UK building societies and international capital markets

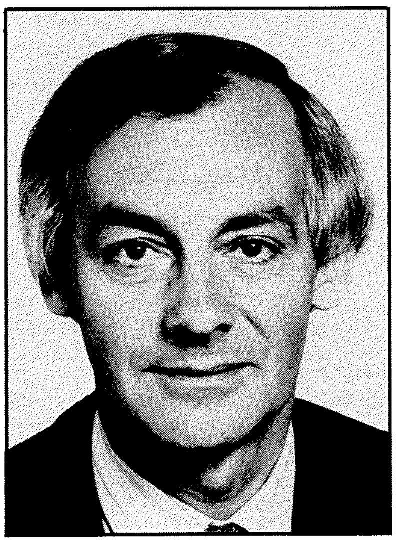
Brian Phillips examines how societies are developing their funding strategies from a widening variety of sources

IN the first issue of *Housing Finance International* I outlined how and why building societies had entered the Eurobond market and discussed the type and volume of issues that had been made. Now, a year later, I would like to examine how societies are continuing to develop their funding strategies against the ever-increasing sources of funds which are available in the international capital markets.

Building societies' funding

The use that societies make of capital markets depends not only upon the opportunities available, but also upon their funding requirements. During 1986 societies' gross mortgage lending totalled £36.6 billion compared with £26.5 billion in 1985. Net receipts from retail investors declined from £7.5 billion to £6.6 billion and the use of capital markets increased from £3.1 billion to £6.1 billion. This included the funds raised from the domestic markets by way of Sterling Certificates of Deposit, Time Deposits, bank loans and index-linked securities.

However, during the first five months of 1987 societies raised only a further £1.3 billion from the capital markets. This may sound surprising as mortgage demand continued at a high level and the cost of capital market funding was extremely attractive compared with retail funding. In fact, the decline reflected the regulatory restrictions under which societies now operate.



'Societies closely monitored by supervisory body'

Prudential supervision

The Building Societies Act 1986 provided that a body of Commissioners, called the Building Societies Commission, be established whose members are appointed by the Treasury. The general functions of the Commission are:

(a) to promote the protection by each building society of the investments of its shareholders and depositors;
(b) to promote the financial stability of building societies generally;
(c) to secure that the principal purpose of building societies remains that of raising, primarily from members, funds for making advances to members secured upon land for their residential use;
(d) to administer the system of regulation of building societies provided for by or under the Building Societies Act 1986; and
(e) to advise and make recommendations to the Treasury or other government departments on any matter relating to building societies.

The Commission has the power to do anything which is calculated to facilitate the discharge of its functions. It is clear, therefore, that societies are very closely monitored by their supervisory body, the Commission. This adds to the excellent security afforded to investors and is an important factor in promoting international interest in building societies' bond issues.

Nevertheless, the Commission's powers may, as we shall see, act as a restraining influence on building societies in a way which can affect their competitive position compared with other lenders in the mortgage market.

The capital markets funding limit

The Act empowers the Building

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Societies Commission to lay regulations before Parliament which fix a limit on the amount of wholesale (capital market) funds which societies are allowed to raise. This limit has initially been set at 20% of total interest bearing liabilities and an upper limit of 40% is laid down in the Act.

The sharp increase in capital market activity in 1986 caused a number of societies' holdings of capital market funds to rise towards the 20% limit. The desire to maintain some headroom, and the lack of any immediate indication that the initial limit would be raised, therefore caused those societies to slow down their capital market funding whilst they began actively to lobby for some relaxation by the authorities.

'Wider access to capital markets vital'

All societies have now agreed that it is vital that they should be allowed wider access to the capital markets in order to remain competitive with the new lenders that have entered the mortgage market. These comprise banks and specialist mortgage finance houses which are financed almost exclusively from the capital markets without similar supervisory restraint.

This matter is now being pursued by The Building Societies Association, which is in the process of making a detailed submission to the Building Societies Commission and hopefully through them to the Treasury.

Sources of funds

The sources of funds available to societies in the domestic market tend to be short term except for syndicated bank loans and index-linked securities. An improved capital structure will therefore dictate that societies continue to maximise their international funding opportunities.

Building Society Funding

Date	Society	Initial Amount	Term Years	L/F*	Lead Bank
Eurosterling Issues		*£m*			
1986					
June	Abbey National	200	7	L	Samuel Montagu
	Nationwide	250	10	L	Baring Bros
	Alliance & Leicester	300	8	L	Morgan Guaranty
July	Alliance & Leicester	75	5	F	Citicorp
	Halifax	100	7	F	Morgan Grenfell
August	Britannia	150	10	L	Hambros
	Abbey National	500	5	L	Samuel Montagu
September	Halifax	150	10	L	Credit Suisse First Boston
	Halifax	150	10	L	Credit Suisse First Boston
	Anglia	150	10	L	SG Warburg
	Nationwide	300	10	L	Baring Bros
1987					
February	Halifax	100	10	F	Morgan Grenfell
	Alliance & Leicester	40	5	F	Bankers Trust
March	Cheltenham & Gloucester	50	5	F	Union Bank of Switzerland
	Leeds Permanent	50	5	F	Baring Bros
	Woolwich	50	5	F	Chase Investment Bank
May	Halifax	50	5	F/L	Morgan Grenfell
Eurodollar Issues		*$m*			
1987					
January	Halifax	150	5	F	Credit Suisse First Boston
	Abbey National	200	5	F	Morgan Grenfell
February	Woolwich	150	7	F	County Nat West

*L: LIBOR related. F: Fixed rate.
Source: *Building Society News* and press reports.

The table shows that during the summer months of 1986 building society activity in the Euromarkets was heavily weighted towards the issue of Floating Rate Notes. Furthermore, most issues were tied to the three-month interbank rate until investor demand enabled issues to be priced relative to the one- and six-month rates.

'Diversification into the foreign currency market'

The table also shows that 1987 began with an early move towards diversification into the foreign currency market by both the Halifax and Abbey National societies. On 6 January both societies took advantage of the powers in the new Act which enabled societies to tap the foreign currency markets.

The proceeds of the issues of $150 million and $200 million were both swapped into attractively priced variable rate sterling at close to the London Interbank Offered Rate (LIBOR). These issues were followed by a similar issue of $150 million by the Woolwich Building Society on 13 February.

The most interesting factor shown by the table is that there have been no Floating Rate Note issues since September last year. This has reflected the increases in yields that have occurred in the Floating Rate

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Note markets, a subject I shall refer to later, and the indigestion caused by the amount of building society paper issued in such a short time.

Against this background societies have raised £340 million so far in 1987 from the fixed rate Eurosterling market. This equates approximately to the sterling value of the three US dollar issues. In addition to these bond issues, a number of societies have taken steps to raise foreign currency funds from the shorter-term Eurodollar markets.

'Huge market that has not yet been tapped'

They have done this by announcing programmes to issue Certificates of Deposit (CDs). These, when issued, will trade in the commercial paper market and, in addition to providing a useful source of funds, the costs may be favourable compared with the sterling CD market.

Future strategy

The speed at which societies have built up capital market funding has demonstrated the enthusiastic manner in which a wide range of domestic and international investors, who understand building societies and the UK housing market, have responded to the attractions of the investments offered. This supportive group has, however, largely represented organisations whose knowledge results from their presence in London.

There remains a huge market that has not yet been tapped. This is made up of overseas private and institutional investors who invest in those names that have already established a well-known international name. A great deal of promotional work remains to be done by societies to promote their name not only to overseas investors but also with those who distribute investments to the investors.

This process was commenced by the two building society delegations that visited Europe and Japan following the launch of societies into the Euromarkets. Since then a number of societies have made individual trips to Europe, America and the Far East. It remains clear, however, that a significant increase in such activity will be required if building society paper is to acquire a more varied investor base.

Credit rating

Credit rating is becoming an increasingly important qualification for the international fund-raising institution as it enables the investor to rely on a professional agency to evaluate credit standing rather than to become involved in his own detailed assessment. However, many investors continue to be attracted by the name of an investor and its type of business.

This is reflected from time to time by those with slightly lower credit rating obtaining superior terms in the dollar market. To date, British building societies have not needed credit ratings, but as new techniques are adopted and as societies tap new markets such ratings could be of advantage in the future.

'More assured source of funds'

Future activity

As societies broaden their appeal to a wider range of investors they will gain many advantages from being able to raise funds on an international basis. The process will ensure that a wide base gives them a more assured source of funds and that they will be able to choose only those funds that are cost-efficient.

Opportunities may also occur to switch out of some existing sources of funds into newer cost-effective funds and this could become an ongoing process in the effective management process. Furthermore, such a process will add considerable strength to societies' funding base which could be of great future importance as a particular source of funds may, on occasion, dry up.

Recent developments in the international markets

Probably the most significant development in the past year has been the problems that have occurred in the dollar-based perpetual bond market. This deterioration occurred because the paper was widely held by trading houses and resulted from policy decisions to reduce the size of the trading books concerned. The ripple effects have spread through to both dollar and sterling Floating Rate Notes.

'Need for truly international presence'

The other striking feature has been the sharp reduction in dollar denominated issues. This has reflected the extreme weakness of the dollar. There has, however, been a corresponding increase in yen, Deutschmark, ECU and Australian dollar issues. This underlines the importance for institutions to develop a truly international presence to ensure access to funds at all times.

Undoubtedly British building societies will watch developments in these markets with keen interest in order to capitalise on the success which they have enjoyed to date. ■

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