Building societies and the Irish housing finance market

By Dr Michael Walsh

IRELAND'S financial services sector is one of the most rapidly growing sectors of the country's economy. There are some 110 institutions operating in the sector, controlling total assets in excess of IRE25 billion and employing approximately 32,000 people.

The sector comprises the licensed banks, the building societies, the life assurance companies and the non-life assurance companies. In addition, there are in excess of 30 companies engaged in hire purchase finance and/or leasing and a large number of agency operations such as stockbrokers, insurance brokers and investment advisers.

Within the licensed banking system are the four major associated banks, 22 merchant/commercial banks, both Irish and foreign owned, and nine industrial banks. There are also two state-owned trustee savings banks and five other state-owned institutions which specialise in the provision of financial services to various sectors. Over the past decade, the Irish banking system has grown over fourfold in terms of total assets.

The Irish life assurance industry consists of 24 firms controlling total assets in excess of IRE4.6 billion, and with annual premium income in excess of IRE900 million. This segment has grown more than tenfold in the past decade and now forms a central part of the Irish financial and investment environment.

Similarly, the non-life assurance sector in Ireland has also grown strongly in the past decade and total assets have increased over seven times in that period. At present, it consists of 34 companies and total annual premium income is in excess of IRE37 million.

The building society sector is the final element of Ireland's financial services environment. The societies, while small in number, have now emerged to play an important role in the overall structure of the financial sector.

The Irish building society movement

With one exception, the major Irish building societies were formed between 1861 and 1884. They remained small for a long time and their relative importance was limited.

'Societies at a crossroads'

By 1921, there were 23 societies in operation with total assets of £500,000. However, since then the societies have experienced very strong growth; they now occupy an important role in the Irish environment and, in particular, in the housing finance market, which they have traditionally dominated.

There are now 10 building societies in Ireland, with total assets of approximately IRE3.5 billion. Of the 10, the four largest societies (Irish Permanent, First National, Educational and Irish Nationwide) account for just under 90% of all building society resources. However, while the building society movement has experienced strong growth over past decades, the rate of growth has slowed considerably since 1986 and annual growth in total assets and deposits is currently about 9%.

The building society movement is now at a crossroads in its development. The retail financial services market is becoming increasingly integrated and competitive and this fact, combined with changes in the housing market and in the provision of housing finance in Ireland, will have a major impact on the role which the societies continue to play in the financial services environment.

The Irish housing market

Housing markets vary substantially from country to country and it is frequently difficult to draw conclusions from comparisons between them. In particular, differences exist in the level of home ownership and in the provision of housing finance.

A characteristic of the Irish housing market is the relatively high level of owner-occupation. In 1987, out of a total housing stock of 978,000, approximately 78% was owner-occupied. In 1971, the level of owner-occupation was approximately 70% of the total stock.

The level, high by comparison with levels in other countries, has been caused by the fact that home ownership is an attractive option for house-
holds, given the tax concessions and grants which currently prevail in the Irish market.

Similarly, while many families traditionally lived in housing which was rented at a subsidised level from government authorities, these authorities have now introduced very generous purchase conditions for such houses and this is increasing the level of owner-occupation.

A further characteristic of the Irish housing market over the past 16 years has been the dramatic increase in the size of the housing stock. Between 1971 and 1987 the total number of dwellings in Ireland increased from 725,000 to an estimated 978,000. This increase reflected population growth, demographic changes and the replacement of old dwellings.

In the coming years, it is expected that the demand for housing will continue to grow. This growth will be fuelled by an increase in net new household formation and by a fall in the level of emigration from that experienced in the early 1980s.

Mortgage market in Ireland
The mortgage market has been characterised by strong growth over the past two decades. It increased more than ninefold between 1972 and 1987, twice the rate of increase in consumer prices over the same period, and the number of mortgages granted annually has almost doubled over the past 13 years.

In terms of mortgages granted, in 1986 IRC619 million was advanced against mortgages on 27,600 dwellings, of which 10,235 were new houses. In 1987, the market was estimated at IRC657 million, with mortgages advanced on 18,400 houses, of which 10,300 were new houses.

For the future, it is estimated that while the demand for mortgage finance will be less buoyant than in the past, it is still expected to grow strongly. This growth will be fuelled by a number of factors. The high level of emigration, which has emerged in the period since 1981, has reduced considerably and, while it will still be a factor, it is likely to have a minimal effect on the demand for housing finance.

In addition, mortgage interest rates in Ireland have fallen considerably in recent years from their peaks of the late 1970s and the improving economic climate, highlighted by the progress being made in correcting the public finances, will mean that most people will experience increasing disposable incomes in the coming years. Real housing prices in Ireland are also likely to show strong growth.

These factors, combined with the fact that mortgage lenders in Ireland are now becoming more innovative in developing new and attractive products for their customers, should mean that demand for mortgages in Ireland will continue to grow.

Structure of the Irish mortgage market
The mortgage finance market in Ireland is very similar to its British counterpart in that, while the Irish building societies have traditionally dominated the market, that position has been challenged in recent years and the composition of the overall market has changed dramatically. Table 1 outlines this changing composition over the past decade. Although the societies have been dominant in the mortgage lending market in Ireland, their share of the market has fluctuated sharply. At its peak, they accounted for almost 75% of all new mortgages, while typically their share has been above 60%.

However, in 1987 the building
society share of the mortgage market was reduced to 39.6%, its lowest point ever in the period since 1972. This loss of market share was incurred almost exclusively at the expense of the big four commercial banks whose share of the market increased from 12.3% in 1986 to 36.8% in 1987, their largest ever share of the market.

Table 1: Mortgage Loans by Institution (% Shares)

<table>
<thead>
<tr>
<th></th>
<th>Building</th>
<th>Local</th>
<th>Housing</th>
<th>Associated</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Shares</td>
<td>Authorities</td>
<td>Agency</td>
<td>Bank</td>
<td>Company</td>
</tr>
<tr>
<td>1975</td>
<td>66.4</td>
<td>12.5</td>
<td>11.8</td>
<td>12.4</td>
<td>100</td>
</tr>
<tr>
<td>1976</td>
<td>68.6</td>
<td>17.0</td>
<td>12.4</td>
<td>13.0</td>
<td>100</td>
</tr>
<tr>
<td>1980</td>
<td>74.4</td>
<td>19.3</td>
<td>6.6</td>
<td>10.4</td>
<td>100</td>
</tr>
<tr>
<td>1983</td>
<td>77.8</td>
<td>21.2</td>
<td>5.2</td>
<td>7.9</td>
<td>100</td>
</tr>
<tr>
<td>1985</td>
<td>81.1</td>
<td>21.6</td>
<td>9.1</td>
<td>12.0</td>
<td>100</td>
</tr>
<tr>
<td>1987</td>
<td>85.3</td>
<td>22.3</td>
<td>8.3</td>
<td>13.4</td>
<td>100</td>
</tr>
</tbody>
</table>

The big four clearing banks were formally encouraged to enter the mortgage market in 1975 by the government, through favourable taxation treatment of their mortgage lending business. They initially assumed a large share of the market but subsequently let their share decline from 18.8% in 1976 to 3.8% in 1983. Since then, the banks have begun to increase their share again and have announced that they intend to play a more active role in the mortgage market in the future.

The seriousness of their intention to do so can be seen from the dramatic impact which they have made in terms of market share in the past year. For the future the clearing banks represent the biggest threat to the building societies' dominance of the mortgage finance market in Ireland.

Among other sources, government housing agencies, including the Housing Finance Agency, are now also major suppliers of funds for mortgage finance. However, the Irish life assurance companies, once important providers of mortgage finance, have now effectively dropped out of the market.

Much of this competition in the mortgage market in Ireland has been dominated by the fact that, historically, the mortgage lending rate has been below the rate on the domestic interbank market. This policy of keeping the mortgage rate below interbank rates resulted in a position where mortgage finance in Ireland, although cheap, was in short supply. As a result of the negative differential between the mortgage rate and the interbank rate, the Irish insurance companies have withdrawn almost completely from the market and operators funded from the wholesale sources, which have become an important part of the UK market, have not emerged in Ireland.

However, recent developments in this area indicate that a margin is now opening up which would create the opening for a return of the insurance companies to the mortgage market and, indeed, for the emergence of new competitors in the form of mortgage corporations. A situation where mortgage finance is almost the cheapest form of finance in Ireland is no longer in the best interests of those intermediaries operating in the mortgage market, or in the interests of the authorities.

The Irish savings market

The building societies obtain the majority of their funds from the savings of the personal sector. Table 2 shows the distribution of personal sector savings in Ireland in the period 1961 to 1985.

From these figures it can be seen that the building societies have been very successful in attracting funds from the personal sector, increasing their share of personal sector savings from 1.8% in 1961 to an average of 18.7% during the first half of the 1980s.

The strong position of the building societies arose largely because, in the Irish savings market, they enjoyed two advantages over their competitors. Tax on interest earned on building society accounts was deducted at a rate which was favourable relative to other deposit takers in the market, and the confidentiality of building society accounts from the Revenue Commissioners was guaranteed, whereas bank accounts offered no such confidentiality. Societies' extensive

Table 2: Distribution of Personal Sector Savings (% Shares)

<table>
<thead>
<tr>
<th></th>
<th>Banks</th>
<th>Building Societies</th>
<th>State Savings</th>
<th>Life Assurance Institutions</th>
<th>Pension Funds</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1961</td>
<td>34.7</td>
<td>10.3</td>
<td>33.2</td>
<td>25.6</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>1965</td>
<td>33.9</td>
<td>7.0</td>
<td>31.7</td>
<td>27.6</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>1970</td>
<td>31.5</td>
<td>12.8</td>
<td>22.2</td>
<td>14.3</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>1975</td>
<td>25.9</td>
<td>12.2</td>
<td>26.9</td>
<td>13.2</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>1980</td>
<td>12.6</td>
<td>9.9</td>
<td>17.0</td>
<td>23.5</td>
<td>100</td>
<td></td>
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<tr>
<td>1981</td>
<td>12.6</td>
<td>9.9</td>
<td>17.0</td>
<td>23.5</td>
<td>100</td>
<td></td>
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<tr>
<td>1982</td>
<td>12.6</td>
<td>9.9</td>
<td>17.0</td>
<td>23.5</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>1983</td>
<td>12.6</td>
<td>9.9</td>
<td>17.0</td>
<td>23.5</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>1984</td>
<td>22.9</td>
<td>10.3</td>
<td>33.2</td>
<td>25.6</td>
<td>100</td>
<td></td>
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</table>

and growing branch network, and the increased incidence of home ownership, were also factors which contributed to their strong position.

However, the importance of these factors has now either been eliminated or is likely to be reduced in the future. The taxation distortions between building society and bank deposit accounts have been substantially removed and confidentiality has now been extended to all deposit accounts. In addition, as societies' branch networks mature in future years the advantage of the building societies in the savings market will diminish.

The declining competitiveness of the building societies in the personal savings market is reflected in the sharp fall in savings inflows to societies which has occurred in recent years. This is outlined in Table 3.

The Stock Market crash of October 1987 undoubtedly had some short-term impact on these savings flows. In the immediate aftermath of this crash, the insurance sector experienced substantial net outflows as a result of the uncertainty which prevailed, losing out mainly to building society and bank deposit accounts. However, as confidence has gradually been restored to the Stock Market, these funds have returned to the insurance sector and little permanent change in the share of personal savings has resulted.

<table>
<thead>
<tr>
<th>Year</th>
<th>kC Millions</th>
</tr>
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<tbody>
<tr>
<td>1983</td>
<td>18.3</td>
</tr>
<tr>
<td>1984</td>
<td>17.3</td>
</tr>
<tr>
<td>1985</td>
<td>16.6</td>
</tr>
<tr>
<td>1986</td>
<td>15.0</td>
</tr>
<tr>
<td>1987</td>
<td>14.0</td>
</tr>
</tbody>
</table>

Source: Irish Building Societies Association.

The share of the personal savings market lost by building societies has gone almost entirely to the life assurance companies, which have enjoyed favourable taxation treatment in recent years. This comes in the form of tax relief on premiums paid, as well as an exemption from taxation on both income distributed and on capital gains. These taxation advantages, combined with aggressive and skilful marketing, have resulted in a position where life assurance companies now have a very substantial market share.

There is no logical social or economic reason why the Irish insurance sector should have tax biases working in its favour. These tax advantages are diverting the flow of savings away from banks and building societies to the life assurance companies. This is not in the interests of consumers as a whole as it only serves to threaten the economic viability of the bank and building society branch networks and, therefore, the level of financial services on offer to the consumer.

There must be a strong case to be made for the removal of these taxation distortions from the savings market.
market. Competition within the financial services sector should be on the basis of efficiency, management ability and customer service and not, as is currently the case, on the basis of regulatory or taxation distortions which have been imposed on the market.

Competitive position of the building societies

Building societies are unique in the Irish financial services environment. This uniqueness derives from the fact that they have a special legal status, being mutual societies, and also because they are governed by separate legislation, the 1976 Building Societies Act.

In an environment of strong demand for mortgages and little direct competition, the societies were in a strong position to expand. However, in the current environment their position is somewhat less secure and restrictions imposed on their activities by the present legislation have severely hampered their competitive ability.

A major disadvantage faced by the societies is their inability, due to legislative restraints, to market a full range of services to their customers. This is a severe restraint on building society activity, particularly in a retail financial services market which is characterised by frequent and varied transactions. It also places the societies at a severe disadvantage relative to their main competitors, the banks, whose broader product range gives them access to more lucrative lending opportunities such as personal loans, as well as access to very low-cost funds such as current accounts.

The future competitive ability of the societies is also hampered by legal restrictions regarding their capital base. The societies are mutual organisations and they can only add to their permanent capital base through retained earnings. Thus, the pace at which the building societies can expand their range of activities is governed by the profitability of existing activities.

The clearing banks, by comparison, can expand their permanent capital base using both retained earnings and additional equity, as well as having greater opportunity for engaging in off-balance sheet financing.

Changes in building society legislation

As competition in the mortgage market in Ireland intensified, it became clear that if the building societies were to be given an opportunity to maintain their competitive position and contribute to the future development of the financial services sector, the distortions which currently hamper the societies had to be removed. Accordingly, last November radical changes in the legislation governing the building societies were announced by the Minister of the Environment.

These changes will contribute to the most radical reform of the Irish building society movement since its foundation over a century ago. In some ways this new legislation is likely to be similar to that which was introduced in the UK under the 1986 Building Societies Act. However, it will differ in that responsibility for regulatory control of the societies will automatically be transferred to the Central Bank of Ireland. Both pieces of legislation were undoubtedly motivated by the desire to allow building societies to develop in the rapidly changing financial environment.

The proposed legislation will have significant impact on societies’ activities in the coming years. It proposes to liberalise their power in a number of important respects:

(a) The societies will be given wide powers to become involved in the provision of financial services generally which would include banking-type services (money transmission, credit cards, foreign exchange, etc), insurance broking, investment services and financial advisory services. These increased powers are likely to improve the overall efficiency of the retail financial markets and will generate increased competition in all aspects of the supply of personal sector financial services. As such, they are most welcome.

(b) For the first time, societies will be permitted to lend unsecured.

(c) Societies will be permitted to own property for residential development. This is an activity which has been very attractive for some of the largest societies in the UK, and the experience of Irish societies is likely to be similarly favourable.

(d) In addition, societies will no longer have to rely solely on the retail savings market for their funds. They will be permitted to raise finance on the wholesale money markets and to issue instruments such as bonds, eurobonds, certificates of deposit and mortgage-backed securities.

(e) Most importantly, perhaps, the new legislation promises to include a provision for societies to lose their mutual status and convert to public limited company status if the members wish to do so. The option of flotation on the Stock Market would then become a reality. This access to equity finance becomes particularly important if building societies make the investments necessary to achieve economies of scale and if they are to have the flexibility to compete effectively in the modern financial services market.

The new building society legislation, when introduced, will provide a framework for the deregulation of the building societies so that they can compete effectively in the wider financial services marketplace. However, while the new legislation promises much, it cannot be emphasised enough that there is a need for this new legislation to be sufficiently
flexible to allow the societies to respond to the many challenges and opportunities which will confront them.

The future for building societies
With the promised new legislation, the societies can face the future with a mixture of anticipation and trepidation. The powers soon to be bestowed on them will place them in a strong competitive position. They already have a number of competitive strengths which should allow them to become major players in the future of the financial services market. The main strengths are:

(a) Building societies have very large customer bases. The largest building society in Ireland, the Irish Permanent, with total assets of IRE1.3 billion, has in excess of 300,000 customer accounts, while the Irish Civil Service Building Society, the fifth largest in Ireland with total assets of IRE233 million, has in the region of 30,000 customer accounts. This large customer base is a position of particular strength as financial service companies look to future sources of profits. Financial innovation in wholesale financial markets has reduced profit margins in corporate and investment banking. The slower rate of change in retail financial markets has left the retail market offering good profits to institutions with the right products.

(b) Building societies also have very good retail networks and cross-selling opportunities will undoubtedly arise from the reforms promised in the new legislation.

(c) Building societies also have skills, built up over the years, in secured lending on property that will remain with them in the new environment.

(d) Their late entry into the high technology of modern financial markets should allow them to acquire state-of-the-art technology quite cheaply.

(e) In addition, after years of strong profitability in the housing finance market, the large societies have built up substantial reserve bases which should allow them to become major competitors in future financial markets.

However, there are also some valid reasons for the societies to face the future with caution. These new opportunities also offer new risks. By and large, Irish building societies do not have the managerial and staff experience to compete effectively with other institutions in retail financial markets. They are also particularly short of skills in the areas they want to enter.

In addition, their low cost base is suited to selling one or at least very few financial products. To expand this product base, high developmental costs and potential risky experiments will have to be tried, which could increase costs substantially.

Conclusion
In the financial services industry, competition between different participants should not be on the basis of tax biases or other artificially imposed disparities, as has frequently been the case in the past. Instead, competitors should be in opposition to each other on the basis of initiative and enterprise. The new building society legislation for Ireland is a large step towards creating such an environment.

In this environment, building societies will have to rely for their survival on skills which many have yet to develop. Their ability to adjust to this changing environment and to meet the demands of their customers for new services will determine whether or not they will be successful.

The Irish building societies can play a major role in the future development of the retail financial market. Given the right regulatory environment, some of the largest Irish societies will also start to compete for business in the international markets. In such a scenario the ultimate beneficiary will be the consumer and the financial services environment in general.

DR MICHAEL WALSH is a director of National & City Brokers Group.