The effect of global financial developments on building societies

By John G. Heimann

THE structure of the financial services industry is changing dramatically. Deregulation — the opening up of domestic financial markets to international competition and the abolition of exchange controls and other restrictions — is sweeping around the globe. Free market principles are being embraced by countries as different in outlook and development as France and Chile, Canada and the Soviet Union, bringing in their wake a spate of liberalisation measures. A new phase of market capitalism — global, rather than national — has been irreversibly established.

Wherever we look, we can see the powerful effect of the globalisation of capital on the world's economy. The pace of growth in international money flows is nothing short of astonishing. Last year a staggering US$10 trillion of securitised funds moved across national frontiers. Global financial transactions currently amount to a historically high multiple of the volume of world trade. Foreign exchange transactions alone are in excess of US$500 billion a day. It is clearly the movement of capital — not trade — that is driving the economic and financial world.

More specifically, we can point to the extent to which the vast accumulation of savings in Japan is channelled through institutions and intermediaries into overseas investments. We can also see the growing proportion of foreign trading in equities and foreign bonds fuelled by the expanding appetite of institutional investors

in the United States and Europe for non-domestic securities. 'Thrifts' and building societies have already begun to tap non-domestic sources of capital in meeting their financing requirements.

What does all this portend for financial institutions — and in particular the world's building societies and savings institutions? My paper concentrates on four broad inter-related themes or issues –

(a) Globalisation and its impact on the structure of building societies and the services they provide.
(b) Deregulation and the increasing competitive pressures that have resulted.
(c) The capital base of the industry and the need to ensure that it is adequate to meet the pressures and opportunities that are facing individual institutions.
(d) The need for effective supervision and regulation in this sector of the financial services industry.

Globalisation

In order to foresee the role of savings and home loan institutions in a global capital market system, the first step is to identify the probable dimensions of the financial intermediary system as it is currently developing. What is becoming abundantly clear is that we will have a two-tiered capital market: a global market for the securities of well-known, highly rated issuers; and local markets which will meet the financing needs of non-global issuers. These markets will be intermediated by global financial institutions, in the first instance, and by local intermediaries in the second.

It should be stressed that local does not mean small. It does mean an institution which has chosen to concentrate its activities in its home country. Therefore, it may be very large, even dominant, at home. Its financing needs will be denominated in local currency and its issues will best be received in a market in which it is well-known and respected.

It is true to say that the sweeping changes that have already transformed the wholesale capital markets have only begun to leave their mark on most of the retail sectors of the financial services industry. I would include here the building societies and savings institutions. The housing finance industry with its

heavy dependence on branch networks has tightly restrictive barriers to entry as the clearing banks, insurance companies and specialist mortgage lenders have discovered in the United Kingdom, for example.

There, the building societies' share of mortgages outstanding is still above 70% and has actually risen in recent years despite the widespread entry of other lenders and the proliferation of competition. Other local practices — particularly statutory obstacles — have also effectively compartmentalised the industry within national boundaries. With the onset of securitisation of mortgages in the UK and France we may soon be seeing the emergence of an increasingly international marketplace for housing finance.

Within the European Community, the 1992 proposals for a single market will arguably have their greatest impact on the retail sector of the financial services industry. We are beginning to see an increasing number of financial institutions respond to these changes — through mergers, joint ventures and other forms of working relationships. What is abundantly clear is that there are serious imperfections in the market which represent enormous business opportunities for financial institutions from other countries, either within the Community or elsewhere. In the mortgage market within the EC, there are vast differences from country to country in the cost of home loans.

In Spain, I understand that the annual cost of a home loan (measured in terms of the excess of mortgage rates above money market rates) is more than double the cost in the UK. While many sectors of the wholesale financial markets can be said to have been arbitraged to perfection, the opportunities for cross-border competition in the retail markets are self-evident. The 1992 European market, with the single passport concept, will clearly facilitate this process. Financial intermediaries within the European Community will be capable of conducting their business in any country of the EC as long as they are authorised in their home country within the Community.

Deregulation and competititon

For the world's building societies and savings associations, deregulation is an increasingly predominant theme. Historically, in many countries in Europe, in Australia and to a lesser extent in the USA, mutual savings institutions — established on the co-operative principle of one member/one vote — have operated in a highly regulated and restricted environment. There have been distinct areas of demarcation between the products and services offered by the building societies, and those provided by the commercial banks. More and more these distinctions are being eroded and the building societies and savings institutions are competing head-on with their commercial banking rivals in the housing, savings and retail banking markets.

In the UK, building societies, as elsewhere, are governed and regulated in their activities by statute. The Building Societies Act 1986, the central legislative framework, substantially liberalised societies by allowing them to expand their operations in the housing field and to provide ancillary financial services to their customers. Those of the top ten societies that have decided to pursue a retail banking strategy now offer current accounts, cheque cards, credit cards and ATM services to their clients.

More importantly, perhaps, the 1986 Act established the basis on which members could vote to convert their society into a public limited company with full banking status, a process that has been under way for some time in the United States. It will also be possible in the future for members to vote to accept a takeover by a non-society, provided that the successor entity receives authorised banking status. The voting requirements of members in favour of an acquisition, as laid down in the Act, are more rigorous than for a conversion. Notwithstanding this, the outcome of the Abbey National vote on conversion suggests that — at the right price — members may be prepared to vote in sufficient numbers to approve the special resolutions in respect of an acquisition of a society by, for example, a bank or an insurance company.

The acquisition of a building society provides immediate access to UK retail banking — in its broadest sense. There are a number of financial institutions that have publicly declared their interest in concluding negotiations with a willing seller, and there is currently much speculation about the feasibility or otherwise of acquiring a building society on a "hostile basis".

In the United States, savings and loans institutions have for some years enjoyed the freedom to convert from mutual status to joint stock companies. Since 1982, Merrill Lynch has advised on more than 90 thrift conversions. As is generally known, the thrift industry in the United States has been plagued with a number of problems recently. In some cases, the management of thrifts have unwisely applied the capital raised on conversion to support highly speculative investments. In addition, the structural mismatch between making long-term fixed rate loans and taking short-term variable rate deposits has led to dramatic losses on mortgage portfolios during periods of interest rate volatility.

The problems of the US S&L associations are well known, chronicled, as they have been in minute detail, through Congressional hearings. And, of course, Congress has taken action to safeguard the depositors in thrifts and effectively restructure the S&L industry. This is not the forum for a rehash of what went wrong, why, and who was a fault. Nor would it be appropriate to discuss the strengths and potential weaknesses

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in the recently enacted Financial Institutions Recovery, Reform and Enforcement Act. Rather, it would be helpful to see what lessons can be learnt from the enormous past mistakes so that we will not repeat them in the future.

First and foremost, the users of financial services will not be served by, nor will they tolerate, less than fully competitive products and prices. In a private system, competition is the driving force, and innovation is a primary tool. Those institutions which cannot meet competitive standards, for whatever reasons, will fall by the wayside. No longer do depository institutions enjoy special protective treatment. Therefore, they must compete in order to survive and to do this successfully they must offer that which their customers demand since those customers have the sophistication and capacity to choose. Secondly, the institutions which offer expanded service must have the capability to manage diversification effectively.

In Germany, as the population is simultaneously declining, ageing and becoming more prosperous so the retail banking market is becoming more attractive. This is generating greater competition — not as yet from foreign institutions — but more from the large Frankfurt banks as they pursue the concept of "Allfinanz". All three big banks, Deutsche, Commerzbank and Dresdner, have recently undertaken restructuring of their mortgage finance business and have followed this with plans to improve their profile in life assurance. As prosperity increases, we have seen a growth in the volume and sophistication of savings. Thus the proportion of German personal sector savings going into insurance policies has risen in the last ten years from under 20% to 30%. The "Allfinanz" concept — the provision of a wider range of services beyond the traditional loan/deposit relationship — is becoming the predominant retail banking strategy.

The purchase of one's own home is the single largest and most important financial transaction that an individual will undertake. As such, the provision of the mortgage is perhaps the pivotal financial relationship. From the point of view of the providers of this loan, the mortgage business has the dual attraction not only of involving generally low-risk/high quality assets but also of presenting opportunities for cross selling other financial services.

In their home markets building societies and savings institutions almost universally have a strong foothold; and there are substantial barriers to entry for non-domestic institutions. The housing finance and mortgage systems in Europe are far from homogeneous and the legal system for transfer of ownership of residential property varies from country to country. Creating a distribution network from scratch and securing a funding base, whether retail or wholesale, is a particularly expensive exercise. Competition, therefore, in these increasingly deregulated markets is likely to come more from within than from foreign institutions and we can expect to see much consolidation amongst societies and savings institutions.

Capital

Growth and competition will be affected as much as anything by having access to sufficient capital. The central banks of the G-10 countries, under the auspices of the Cooke Committee, have reached agreement on establishing common minimum standards for the capital adequacy of their commercial banks. These new risk-based capital guidelines have been causing commercial banks to restructure their capital bases. This has given rise to a plethora of new financial innovations — such as Variable Rate Notes and Direct Issued Preferred Stock, both of which Merrill Lynch has pioneered.

Since the beginning of 1988 — when it became clear which types of instruments would count as Tier I and Tier II capital for regulatory purposes — Merrill Lynch has raised more than US$9.0 billion in capital for US and European financial institutions in the form of equity, preference shares and subordinated debt issues.

Currently, the Basle Committee's paper on international convergence of capital standards does not directly effect many of the world's major savings institutions and building societies. In the United Kingdom, for example, the Building Societies Commission has a separate calculus for determining the capital adequacy of the institutions under its supervision. Nevertheless, in its 1989 Annual Report the Commission points out that — measured by the Basle Committee's rules — the solvency ratios of the largest 46 societies all exceeded the proposed minimum requirement of 8% by at least 1%, and the weighted average was over 11%. In fact, all the UK building societies would already meet the minimum requirements of the Basle Agreement if it were to be enforced now, and the majority would do so by a comfortable margin.

As societies position themselves to meet the challenges of the next decade, the question of capital allocation will become increasingly important. Without a Tier I equity instrument, mutual institutions must consider carefully the extent to which they wish to diversify, particularly where this is more capital intensive than their traditional business. Moves are afoot, in the UK as elsewhere, to create — for mutual organisations — shares with some of the characteristics of equity or ordinary shares in a company.

In Australia, at least one society has issued permanent shares which count as Tier I capital without compromising its mutual status. For many institutions there are technical and wider conceptual issues to be wrestled with before a real equity instrument comes into being. Capital, in the form of accumulated

reserves, term subordinated debt, and perpetual subordinated debt — which is likely to come into being in the UK in early 1990 — remain the only viable sources of capital for the time being.

The absence of equity and preference shares, as a means of raising Tier I capital for societies, make the idea of a "level playing field" a nonsense. Societies will be severely constrained in their ability to compete with their commercial banking rivals as long as they are prohibited from raising Tier I capital. The competitive advantage of those with access to these markets is dramatic, as evidenced by the recent US$ preference share issues by UK and Irish clearing banks which have enabled them to raise substantial amounts of Tier I capital at a fixed cost below 10%. Although societies are sufficiently capitalised at present, it should not be the case that they are forced to forego mutual status in the form of conversion, or acquisition by a third party, in order to plan with certainty for growth and diversification. For the major societies, which compete — in reality — not with other smaller societies, but with the large commercial banks, these issues are particularly vexing.

For smaller — regional — organisations a plan for growth built around niche marketing will continue to be a winning formula. These organisations will prosper doing what they have been successful at for many years — taking deposits and making home loans.

In the United States, a strategy that embraces strong regional concentration has served many thrifts — and commercial banks as well. For example, the strategy of acquiring small regional banks that can be moulded into a substantial and profitable regional banking organisation has proved very successful for Ohio's Banc One Corporation. The question of capital adequacy for many smaller organisations pursuing a strategy of limited diversification may not — for the moment — represent a problem. For those major societies that have already embarked on a "high street" confrontation with the retail banks, the issue is more pressing.

The changes in the housing finance markets that I have attempted to summarise are unquestionably bringing major benefits to the consumer. Greater competition is providing a wider choice of lenders and mortgage products, and at a lower cost than ever before. But while the emerging marketplace is full of new opportunities, prudence dictates that we pay attention to the problems and the risks.

Supervision and regulation

I have already alluded to one of the main areas of risk opened up by the deregulation of savings institutions — the mismatch between deposits and loans which has resulted in the well-publicised problems affecting the industry in the United States. There are clearly other areas and categories of risks. Securitisation of mortgage assets, for example, removes the direct relationship between lender and borrower and therefore one might assume diminishes the extent to which lenders can oversee their mortgage loans. As competition intensifies, there is likely to be an increasing tendency for savings institutions to break out of their traditional territories and pursue lending opportunities with which they are less familiar and which in some cases may involve significantly higher risks.

I have referred to the substantial progress of the G-10 central banks in establishing common minimum standards for the capital adequacy of their commercial banks. Outside commercial banking, one can see substantially less progress towards international harmonisation and common standards setting. The agenda is a long one, covering a vast range of issues from taxation and accounting standards to capital adequacy and conduct of business rules. A significant part of the problem is that there is no mechanism, similar to the Cooke Committee of the Bank for International Settlements, to review the regulation of non-banking institutions on an international basis. Efforts to broaden the scope of regulatory review beyond commercial banking are clearly needed.

I have described in this paper the increasing challenges that are represented by the twin processes of globalisation and deregulation. As never before, the housing finance industry is faced with a bewildering array of strategic issues and opportunities. In their domestic markets, the indigenous savings institutions tend to have a strong foothold. Carefully planned diversification into new markets, new product areas, and possibly other countries will undoubtedly pay dividends for those institutions with the capital to support them and with clearly considered and effectively implemented strategies.

Regional or local concentration on niche markets will serve many other smaller organisations — without the capital or ambition to take on the 'financial supermarkets'. There will be many who choose to join with others to face the challenges of the 1990s, and some who will formalise their existing links with insurance companies and other providers of financial services to form powerful multi-product organisations. The boundaries between the housing finance market and other sectors of the retail financial services industry are likely to become increasingly blurred.

In conclusion, perhaps I may end by offering a note of caution, Ambrose Bierce's definition of an acquaintance: "A person whom we know well enough to borrow from, but not well enough to lend to". ■

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