Recent Developments in the UK Savings Market

By Adrian Coles

Introduction

THIS paper examines recent trends in the UK savings market, paying particular attention to the progress made by building societies. However, it also reviews the activities of National Savings, the government sponsored savings organisation, and the commercial banks and comments on the impact of developments in the equity markets on the flow of personal sector savings. The paper describes the changes in the taxation of interest earned on savings and a new government scheme to be offered by private sector institutions. The paper concludes with an examination of the outlook for the savings market.

Building Societies

Building societies are specialised financial institutions with two principal functions - to accept deposits from members of the public and to provide loans to people who wish to buy their own homes. They are mutual institutions, owned by their customers, and operate under their own specific legislation, rather than the more general company or banking laws. The current legislation is the Building Societies Act 1986, which came into effect on 1 January 1987. The Act replaced an Act of 1962, which drew many of its provisions from an Act of 1874, and significantly widened societies' powers. Currently, there are 101 societies authorised by the Building Societies Commission, the government appointed prudential supervisors, to accept investments from members of the public. Building societies are able to operate throughout the entire country if they wish. The largest is the Halifax Building Society which has well over 10,000 employees, operates through 750 branches and has around 10 million investors and 1.7 million borrowers. Around a dozen other societies have branches throughout the country. A number of societies operate on a regional basis, in just part of the country, and there remain a large number of small societies confining their operations to the district immediately surrounding their head office.

As noted above, building societies are mutual institutions; that is they are owned by their investors and borrowers. Most of those individuals depositing their savings with building societies open what is known technically as a share account, although there is no similarity between building society share accounts and equities traded on the stock exchange. However, ownership of a share account does convey membership rights and investors are able to attend general meetings, propose and vote on motions and stand for election to the board of directors. The vast majority of investors do not take an active interest in the affairs of their society, being concerned merely with earning a competitive rate of interest on their savings.

Building societies' principal competitors in the short-term savings market are the commercial banks and the government sponsored National Savings. For funds that are not required immediately, investors are able to invest funds directly into equities, into unit trusts, which are collective open-ended investment schemes investing in a wide range of equities and government bonds, and over the very long term in life assurance savings and pension schemes.

Building Societies and the Short-Term Savings Market

Building societies have been extremely successful in the short-term savings market. The conversion of Abbey National from building society to bank status confuses the long-term statistics somewhat, but if Abbey National is still counted as a building society, societies' market share of short-term assets rose from about one-quarter in the mid-1960s to over one half by the late 1980s. Similarly the proportion of adults investing in building societies grew rapidly from just 15% in 1968 to 69% by 1989.

It is tempting for building societies to claim the entire credit for their success for themselves. They have an outstanding reputation for safety and friendliness. No investor in a building society has lost any of their savings since at least 1945 and probably for some time before. Societies have a large number of well located branches that, in general terms, are open for longer hours than those of the banks. Their savings facilities have been aggressively advertised.

Nevertheless, it has to be recognised that part of societies' success has been due to factors outside their control. In particular, until the early 1980s, banks were prevented from playing as full a part as they would wish in the savings market by controls in the growth of the money supply, which was defined in terms of bank balance sheets. In essence, from time to time, during the 1970s those banks that grew too quickly were penalised by having to make special non-interest earning deposits with the Bank of England. Building societies suffered no such restrictions and indeed for a period from late 1973 until the middle of 1975 bank interest rates available to the public were kept down by the government, in order to ensure that building society rates remained higher, so as to enable them to attract funds to meet the demand for mortgages. Since 1980, however, the competitive conditions facing banks and building societies have been broadly similar.

Building societies raise the vast proportion of their funds in the form of passbook savings accounts on which withdrawals can be made at no notice and with no interest penalty. Nevertheless, over the past twenty years or so, there have been a large number of marketing initiatives.

In the early 1970s building societies had around 90% of their invested funds in what were called ordinary share accounts. Withdrawals from these accounts could be made at no notice, with investments and withdrawals being recorded in a passbook. Throughout the 1950s and 1960s societies offered virtually no other accounts. Little attempt was made to differentiate markets and it was assumed that the same savings product would appeal to all types of investors whatever their particular characteristics or requirements.

During the 1970s, however, a range of new schemes were introduced. The 1970s were characterised by political interference in the process of setting the mortgage rate. Mortgage rates in Britain are variable at virtually no notice. This needs to be the case because building societies need to change the rate of interest on their short-term savings accounts at virtually no notice in response to changes in interest rates in the rest of the economy. If this was not possible they could lose funds to competing institutions. During the 1970s, however, political intervention meant that societies were not always able to increase their interest rates to the extent dictated by market conditions. In general terms politicians were keen to see the mortgage rate kept at as low a level as possible.

Building societies therefore introduced a range of what were called term shares. Under these schemes investors agreed to leave their money deposited with the building society for a fixed period, in return for being paid a fixed differential over the variable ordinary share rate. Initially terms of two years were offered, but during the 1970s this was extended and by 1980 terms of up to six years were available. Term shares meant that a higher rate of interest could be offered to investors without increasing the rate paid on the bulk of societies' savings, and they also offered some protection to societies when competing rates increased and they were unable to increase their own rates to discourage withdrawals.

One of the problems with term shares was that they needed refinancing at the end of the contractual term. Societies overcame this problem by offering to pay the same differential over the ordinary share rate after the end of the contractual term, with the investor being able to withdraw his funds at, say, three months' notice.

The early 1980s saw further changes to societies' product range. There was a gap in the market place between long-term term shares and the instant access ordinary account, and this was filled in 1980 and 1981 with the introduction of short notice accounts. Many societies offered a higher rate of interest in return for three months notice being given of withdrawals. During the early 1980s the periods of notice required by investors in order to obtain higher rates of interest were reduced. By the beginning of 1982 accounts requiring 28 days notice of withdrawal were common and in the middle of that year the first seven days' notice account was launched.

The concept of the term share also gradually altered. Under the conditions applying to the original term shares no withdrawals were permitted during the term. By the mid-1980s, however, most term share contracts allowed early withdrawals, albeit with some interest rate penalty.

By the middle 1980s intense competition between individual building societies, and between building societies in general and banks, meant that notice periods had been reduced to virtually zero. Building societies introduced a range of accounts offering instant access to funds, but which offered significantly higher rates of interest than the old ordinary share account.

Recent Developments

There have been two important recent developments. Firstly, for much of the 1970s and 1980s the rate of interest available on an account depended on the period of notice which the investor was prepared to give before making a withdrawal. Although almost all funds were raised on a variable rate basis, in general terms the longer the period of notice the higher the rate of interest. By 1990 this concept had diminished in importance with rates of interest determined much more by the size of the investment. In general terms, higher rates of interest are now paid on larger investments and it is thought that this has led to some consolidation of account holdings. One large society has recently ceased paying any interest at all on investments of less than £100.

Secondly, societies now offer a much wider range of services. During the late 1980s a large number of building societies introduced full service current accounts, offering not only attractive rates of interest but also cheque book facilities with standing orders, direct debits travellers cheques and foreign exchange and access to cash through cash dispensers. A number of societies appeared to be offering these additional facilities without reducing the rates of interest which they were prepared to pay to attract funds. This has resulted in a blurring of the distinction between balances held for the purpose of saving and balances held pending transactions. Even if they do not offer cheque book accounts, and probably around 20 societies do so, most large societies and a number of smaller ones offer access to funds through cash dispensers.

Building Society Account Holdings

There are two distinguishing features of the investment side of building societies' business. Firstly, the vast majority of funds are kept in a relatively small number of accounts. At the end of 1989 45% of savings accounts each had less than £100 in them. These accounts represented just 0.3% of outstanding balances. In contrast, the 8% of accounts each with sums invested in excess of £10,000 accounted for around 67% of balances. Building societies, therefore, have a large number of small investors but rely typically on a small number of large investors, who have become increasingly interest sensitive over the last few years.

The other major characteristic of investment in building societies is its age distribution. The vast majority of funds invested in building societies are held by elderly people. It is no longer necessary to hold a building society savings account in order to obtain a mortgage loan and, indeed, savings by young people in preparation for house purchase always accounted for a relatively small proportion of invested funds. The figures correspond to the life-cycle hypothesis that one would expect to see. Young people are able to make only fairly modest investments and, indeed, become net debtors when they borrow funds in order to purchase a house. When they reach the age of 40 or 50, their children are leaving home, life insurance policies are maturing, they are inheriting considerable sums, and mortgage payments take a much smaller proportion of their income. They are thus then in a position to save funds and this is reflected in the figures.

Competition from National Savings

In general terms the importance of the government controlled National Saving schemes has declined over the years. However, during the 1980s government competition for personal sector funds has at times been extremely important.

The extent of the competition has depended on the state of the government's finances. During those years in which the public sector has recorded a significant deficit, competition for new savings from National Savings has been intense. On the other hand, recently the government has run a considerable surplus. In this case the rates of interest paid on National Savings' products have been kept at an uncompetitive level. Indeed, balances outstanding have declined in recent years.

National Savings offers a range of products that are distinct from that offered by the private sector. There are five main groups of products -

(a) National Savings Certificates. These offer rates of interest that are fixed for up to five years; there is a substantial penalty for withdrawing funds early. In general terms neither banks nor building societies offer fixed rate accounts.

(b) Index-linked certificates. Capital invested in these certificates is protected against inflation and in addition the government contracts to pay a rate of interest over and above the inflation rate. Currently the real rate of interest paid is in excess of 4%. Interest on both index-linked and conventional fixed rate certificates is free of UK income tax.

(c) Income Bonds. These accounts require the investment of a considerable lump sum but pay interest on a monthly basis. They are direct competitors to similar schemes run by building societies.

(d) Regular Savings Accounts. Regular savings accounts have generally not found favour with banks or building societies. However, National Savings offers the Yearly Plan, which enables an individual to save regularly for a year, using the sum built up to purchase a fixed interest certificate which is then held for a further four years to obtain the highest rate of interest.

(e) Premium Bonds. on this scheme individuals buy bonds on which no interest is paid. The interest goes into a prize fund and bond numbers are selected randomly by computer. Individuals can win prizes of up to £250,000, while retaining the nominal value of their bond.

Banks

As noted earlier, banks were inhibited from playing their full part in the savings market by the monetary controls imposed by the authorities during the 1970s. During that period they generally offered only two types of accounts to the public: the *current account*, which was a full service chequing account, but on which no interest was paid, and a *seven days' notice deposit account* which offered relatively modest rates of interest. During the 1980s the banks have significantly increased the range of accounts which they offer, and indeed many of their savings accounts are now indistinguishable from those offered by building societies. A particularly important change, made as a result of competitive pressures from building societies, has been the decision to pay interest on current accounts.

Competition From the Equity Markets

Until the mid-1980s a paper on building society activity in the savings market would not need to mention competition from the equity markets. The proportion of equities owned by individuals has fallen steadily in the post-war years. In 1957 around 66% of all equities were owned by individuals, but by 1989 this figure had fallen to around 20%.

The new conservative government elected in 1979 initially did not make extending individual share ownership one of its priorities. However, the situation changed during the early 1980s, when the government began to reverse the downward trend in individual share ownership through the promotion of employee share ownership schemes, personal equity plans and most importantly through its privatisation programme.

Employee share ownership schemes are relatively unimportant. Personal equity plans, though, have assumed an increasingly important role over the past few years. They allow individuals to invest a limited amount of funds each year in the equity markets, with both the income and capital gains from such investments exempt from all personal taxation.

The most important change, however, has been the privatisation programme. During the mid-1980s Nigel Lawson, former Chancellor of the Exchequer, went so far as to say that "the widespread ownership of private property is crucial to the survival of freedom and democracy". From the mid-1980s the government pursued an aggressive policy of selling state-owned corporations. In November 1984 British Telecom, one of the largest telecommunication companies in the world, was privatised (although the government continues to retain a 49% stake in the company) and between 1985 and 1988 British Aerospace, British Gas, British Airways, Rolls Royce, BAA (formerly the British Airports Authority), British steel and the water supply industry followed. In November 1990 the 12 regional electricity distribution companies came to the market and in early 1991 the two electricity generation companies will be floated.

Although not privatisations, individual share ownership has also been boosted by the flotation of the formerly mutual Trustee Savings Banks and of the Abbey National Building Society. Each of these, immediately after flotation, had share registers in excess of three million individuals.

The proportion of adults owning stocks and shares rose almost three fold between 1979 and 1988 from 7% to 20%. However, the evidence suggests that many new shareholders have little interest in long term investment. Many have tended to sell their shares immediately after the flotations, as a characteristic of the privatisation programme has been the availability of instant and large profits; typically the share price has risen sharply, often by 40% or 50%, during the first few days of dealings. Those that have not sold immediately have tended to just hold their shares passively and not become active investors in the stock market. Nevertheless, the overall importance of the privatisation programme as a competitive threat to building societies should not be underestimated. During the 11 years of Conservative government around £30 billion worth of state assets have been sold, with possibly half of the funds used in the purchase of these assets coming from the personal sector.

Unit Trusts

During the mid-1980s unit trusts increased their popularity as equity prices rose rapidly. Between January and October 1987, at the peak of the bull market, the FT ordinary share index rose by over 40% and it was not surprising that inflows into unit trusts increased. In 1980, unit trust net receipts averaged £9 million per month. By 1985, the comparable figure had increased to around £210 million and net new investments into unit trusts reached a peak of £1.16 billion in September 1987.

Following the collapse of world stock market values in October 1987, confidence in equity related investments weakened and building societies have been the major UK beneficiaries. During the first nine months of 1987, when stock market prices were increasing rapidly, building society net receipts averaged around £500 million per month. During 1988, when unit trust receipts fell to very low levels, building societies attracted around £1.25 billion per month. The impact of the crash faded during 1989 and 1990, especially as building societies adopted a strategy during a period of rising interest rates of protecting their borrowers from the full extent of mortgage rate increases. This has left them a little uncompetitive in the savings market and inflows have declined.

The Taxation of Savings

There have been very significant changes in the taxation of interest on savings announced during the past few months. Until April 1991 the position is that interest paid on bank and building society savings accounts suffers tax at source;

that is the investor receives a net rate of interest with the building society or bank discharging liability to basic rate tax, by the payment of what is known as composite rate tax to the Inland Revenue. Those individuals liable to the higher rates of tax need to discharge this liability themselves. In general terms it is not possible for individuals to receive gross payment of interest.

The composite tax rate was set at a level somewhat below the basic rate of tax, to take account of the fact that some depositors would not otherwise pay tax on their interest (because their total income was less than the tax threshold). Therefore, non-taxpayers are not able to reclaim the tax paid on their interest. In effect, for 1989/90, the Inland Revenue determined that around 88% of interest paid to building society and bank investors would be paid to taxpayers, with the remaining 12% paid to non-taxpayers. The composite rate of tax for 1990/91 (which is determined on a previous year basis) was therefore set at 88% of the basic rate. The basic rate for 1989/90 was 25% and therefore the composite rate 1990/1 was set at 22%. The effect of the arrangement is that those individuals liable to a 25% rate of tax had their liability discharged by having 22% paid on their interest. However, non-taxpayers, who in theory should pay no tax at all on their interest because their income is too low, also have 22% paid on their interest. The system was clearly inequitable.

An important change in the taxation system - the independent taxation of husbands and wives - was implemented in April 1990. In the past any investment income received by the wife was treated, for tax purposes, as her husband's. If the husband was a taxpayer then he paid tax on behalf of his wife, even if the wife's total income was so small that tax would not otherwise have been due had she been a single person. Independent taxation of husband and wife meant that this arrangement ceased and non-working wives were allowed to earn £3,005 (in 1990/91) of interest income without paying any tax. As a result of this change the composite rate arrangement became less attractive. There was an incentive for husbands to transfer income generating investments to their wives and for those wives to invest the funds which they then had available in institutions which were able to pay interest gross. Wives had no interest in receiving interest from those institutions which had to account for tax at source, as they were not then able to use the exemption on the first £3,005 of their income.

The possibility therefore arose of a significant flow of funds off-shore, that is to the Isle of Man and the Channel Islands, to institutions which were able to pay interest gross because they were outside the jurisdiction of the UK tax authorities and to National Savings. This was not an attrac tive prospect to the government nor was it so to building societies, especially those that were not able to establish subsidiaries in the Channel Islands or the Isle of Man.

In the March 1990 Budget the government therefore announced that it would abolish the composite rate scheme with effect from April 1991. From that date all banks and building societies will be able to pay interest gross (ie with no tax deducted) to non-taxpayers as long as each non-taxpayer is able to sign the necessary certificate to indicate their status. Those individuals who do not sign the necessary certificate or who are taxpayers will receive their interest with basic rate tax deducted (currently 25%). Unlike under the composite rate scheme, this tax may be reclaimed from the Inland Revenue by the individual where it exceeds the tax (if any) actually due on the interest.

TESSAs (Tax Exempt Special Savings Accounts).

Over the last few years there has been concern expressed by some commentators over the relatively low levels of savings in the UK and pressure on the government to increase the incentives to save. In the March 1990 Budget, the government therefore announced the introduction of a new tax free savings scheme - TESSAs (Tax Exempt Special Savings Accounts). Under these schemes individuals are able to invest up to £1,800 per year over a period of five years (with up to £3,000 invested in the first year provided that total sum invested does not exceed £9,000), earning interest on a gross, non-taxable basis. To obtain the tax exemption no withdrawals of capital can be made within the five year term. However, withdrawals can be made of an amount equivalent to the net amount of interest earned.

Conclusion

The savings market has undergone many changes over the last 10 years resulting in a much greater degree of competition, both between individual institutions, and between different sectors of the market that were previously assumed to act independently. Product innovation has accelerated, and the range of a choice available to consumers has widened. Consumers themselves have become increasingly sophisticated and demanded a higher level of service.

These trends are likely to continue in the 1990s and indeed be intensified by even more rapid technological change and by the dismantling of barriers within the European Community. As a result, institutions will need to pay increasing attention to the needs of consumers as the 1990s progress. ■

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