The Impact of the Single European Market on Housing Finance in the UK

By Mark Boléat

INTRODUCTION

The single European market came into operation at the beginning of 1993. In many areas it has had no noticeable effect. Housing finance is one such area. This paper is largely theoretical, and basically argues that developments at the European Community level are of little relevance to the housing finance market in the United Kingdom, although they are more relevant to housing finance institutions.

THE FUNDAMENTAL CHARACTERISTICS OF HOUSING FINANCE

Different markets have different characteristics which influence the area of operation of the market participants. Some markets, for example, those for hairdressing or car washing, are, by their nature, local, and are not influenced by developments at national or international level. Some markets are regional or national, newspapers being one example, and some are international, jumbo jets and computers being good examples. Within one broad sector one can have a spread of local, regional, national and international markets. Taking education, primary education is a local market, secondary education is more of a regional market, university education is a national market and perpetual education is an international market.

It is important to note that international markets can exist without any attempts to create single markets or to harmonise regulations. The markets for jumbo jets, computers and large financings come into this category.

Housing finance is essentially a national market. It requires a different product in each country, and moreover a distribution system and a servicing system in each country. It is not like the production of, say, brief cases. A brief case that works in Britain will work equally well in France, and a British manufacturer of brief cases simply needs to sell to a French wholesaler, and does not need to set up a distribution or servicing mechanism in France. By contrast, a British mortgage lender wishing to sell mortgage loans in France would have to devise a product that is very different from the product on offer in Britain, would have to establish a distribution mechanism and would have to make arrangements to service the loans over their twenty five year life. It would also be necessary to fund the loans in a different way from mortgage loans in Britain, in that sterling deposits are not a sensible way to fund French franc loans.

Broadly speaking, very little of the knowledge, expertise and market position of a British building society is relevant to providing mortgage loans in France. A building society would start with no name awareness, no product suitable for the French market, little knowledge of the French market and no distribution or servicing mechanism. By contrast, a British building society seeking to sell, say, unit trusts or even potatoes in Britain, begins with powerful advantages of a distribution mechanism, an existing customer base and a name awareness.

The logic for exporting is generally to increase sales for a given overhead, thereby increasing profitability. The marginal cost of exports is less than the average costs because fixed costs have already been paid. With mortgage loans this would not be the case. The average cost of a mortgage loan made by a British building society in France would hardly benefit at all from the fixed costs of the British building society. Indeed, the language barrier would impose a very substantial additional cost.

This analysis should not be interpreted as meaning that building societies and other British mortgage lenders should not seek to operate outside this country. For quite legitimate reasons a number have chosen to do so and others intend to follow. Rather, the analysis is saying there is nothing in the

Text of an address by MARK BOLEAT, Director-General, Council of Mortgage Lenders at a seminar on European Housing Finance organised jointly with the European Network of Housing Research at the School of Advanced Urban Studies, Bristol University, Bristol, 4-5 February 1993.

nature of the mortgage finance market which makes it international, and thus those mortgage lenders which wish to stay operating at the domestic level can do so without putting themselves in an uncompetitive position. This is very different from, for example, the market for aircraft, motor cars or computers. It also suggests that there are dangers from entering foreign markets with unfamiliar systems and generally a foreign language, which need to be balanced against any perceived advantages.

THE IRRELEVANCE OF THE SECOND BANKING DIRECTIVE

The Second Banking Co-ordination Directive is a welcome and significant measure. It reduces the opportunities for national governments to discriminate in favour of their own banking institutions, and against those from other countries. It facilitates the exchange of information between supervisors, the importance of which has been emphasised by the BCCI affair. However, as far as housing finance markets are concerned it is largely irrelevant. The reason why British building societies do not operate in Greece, is not that they require authorisation from the Greek banking authorities but, rather, because they do not think they can make any profit by operating in Greece. Sadly, the Second Banking Directive does nothing to guarantee a profit to those institutions which seek to operate across national borders. It removes an irritant in the form of a requirement to be separately authorised in each state in which one operates, albeit at the expense of imposing bureaucracy, that is the necessity to inform one's supervisor before beginning cross-border activity (an expression which can be interpreted in many differing ways), and the need to file more detailed information where a branch is being established. Interestingly, as a consequence of the Second Banking Directive, there is now more bureaucracy involved when a British bank establishes a branch or undertakes cross-border activity in, say, France or any other European Community country than there is in many countries outside the Community.

The obstacles to cross-border housing finance are differences in land law, tax law, language, financial structures and the long-term nature of mortgage loans, none of which are directly influenced by the Second Banking Directive. The obstacles which it removes are not the obstacles to housing finance institutions operating across national borders.

THE EFFECT OF THE SECOND BANKING DIRECTIVE

This is not to argue that the Second Banking Directive and related measures on capital adequacy, own funds, consolidated supervision and deposit guarantee schemes are not important. They are, and they are important for mortgage lenders as well as for more general banking institutions. This is because they set out the framework for the authorisation and supervision of deposit taking institutions. Most European countries have had to amend their national laws to comply with the various directives. Together with the single European market, they have made inappropriate and increasingly difficult to sustain national legislation which has restricted the activities of some credit institutions. In Italy, for example, banks have not been permitted, in theory at least, to make long term loans, and in Germany particular financing instruments are still reserved to particular types of institution. If the single European market means that a British building society can do in Germany what a German Bausparkasse cannot do then clearly the German authorities will take action to put their own institutions on the same footing as foreign competitors. That at least is the theory. We have already seen that in France an attempt by Barclays Bank to pay interest on current accounts has met with fierce resistance from not only the banks but also the banking regulator, and some non-discriminatory regulations have been introduced to deter Barclays. In Britain the Second Banking Directive has undoubtedly contributed to the deregulation of building societies, if only in a minor way, through them being given power to lend directly in the other member states of the European Community. Longer term, however, the steady stream of directives and other measures from Brussels, which need to be translated into United Kingdom law, not once for banks, but twice for banks and building societies, it is bound to increase the pressure for the two sets of institutions to be regulated by a single body. Interestingly, the Second Banking Directive is being implemented for banks and building societies through a single set of regulations.

The most interesting country to analyse in respect of the impact of the Second Banking Directive is Germany. It has a very segmented banking industry with different regulations applying to the different types of banks. In respect of housing finance, only mortgage banks, and for historical reasons two Bavarian banks, are allowed to issue mortgage bonds, a particularly advantageous financing instrument. Only Bausparkassen are allowed to offer Bausparkasse contracts. It would seem to be in accordance with the non-discrimination provisions of the Treaty of Rome, let alone subsequent developments, that, for example, British building societies cannot issue mortgage bonds or Bausparkasse contracts. The Germans would reply that they can, provided they set up a mortgage bank or Bausparkasse, but this is hardly what the single market is all about. In the event no one is likely to challenge the Germans on this particular point, simply because the German mortgage market is unattractive to foreigners. However, in due course developments at the European level must contribute to a breaking down of the barriers between the various sectors of the German banking industry, and one suspects that the overall beneficiaries will not be specialist institutions from France or Britain, but rather the German banks which are comparatively weak in the retail banking market compared with their counterparts in other countries.

THE EXPERIENCE SO FAR

The experience with cross border housing finance so far is not altogether a happy one. Britain provides the best case study. The British mortgage market has been completely open to all comers for many years. Not only has mortgage lending as such not been supervised, but it has not even been necessary to obtain authorisation to undertake mortgage business. This in itself proves something of an obstacle for some continental institutions, as they do not seem happy in doing something unless it is written down on a piece of official paper that they are permitted to do it. In the mid-1980s the British mortgage market looked very attractive to almost anyone. The market was growing rapidly, house prices were rising rapidly, a good margin could be obtained and bad debts were virtually unheard of. This market attracted a variety of foreign lenders, particularly from America. Citibank, Bank of America, Security Pacific, Chase Manhattan and Chemical Bank all established mortgage lending businesses, and the Mortgage Corporation and Bear Stearns set up centralised lenders with a view to securitising their mortgage assets. The three large Danish mortgage credit institutions, BRF, Kreditforeningen Danmark and Nykredit all entered the British market. From France Credit Agricole, Credit Foncier, Societe Generale, BNP and Credit Lyonnais have all crossed the Channel. The two large Irish banks, Bank of Ireland and Allied Irish Banks, are both significant retail banks in general and mortgage lenders in particular in the United Kingdom. Other mortgage lenders came from Germany, the Netherlands and Italy. It is fair to say that most of the lenders have now reviewed their global activities in the light of changes in market conditions and have decided to concentrate on their core businesses, hence they have stopped lending on mortgage in the United Kingdom, and some have sold their mortgage books. Others would like to sell their mortgage books, but have been unable to. The three Danish lenders have had a particularly hard time, as have a number of the American banks. The Council of Mortgage Lenders enthusiastically embraces the foreign lenders, but sadly it has now lost all of its Danish members, its one Italian member and most of its American members. This experience is very much in line with that of the British retail banks globally. Most have flirted with retail banking in America and more widely, and most have abandoned such international business. At best, it can be only marginally profitable, and at worst it can be very unprofitable.

Only two of the specialist British housing finance lenders have ventured abroad. The Abbey National has established businesses in Spain and Italy and has purchased a French mortgage lending business. Their policy has been well thought out and was designed to be no more than modest in scale, yet it is significant that the international business incurred substantial losses in 1992, and a significant capital injection has had to be made into the French subsidiary. The Woolwich Building Society acquired a mortgage lending business from Midland Bank in France and has set up an Italian lending business. Like the Abbey National it has been relatively modest in scope, thereby minimising the dangers.

Other British building societies, notably the Halifax and the Nationwide, have looked at the European markets and have evaluated opportunities. However, they have yet to make a significant move.

CONCLUSION

The single European market is an important development, but it is of little direct relevance to mortgage lending in the same way as it is of little direct relevance to hairdressing, primary education or local newspapers. However, there is no doubt that a true single market is gradually becoming established. Even the language barrier, perhaps the most important of all, is being overcome over time. People increasingly are travelling abroad for business, pleasure and even to work. Financial institutions have to meet the needs of their customers and those needs are increasingly international. The development of financial markets generally has led to a breaking down of barriers between institutions and submarkets, and the single market programme has undoubtedly accelerated this process. Mortgage finance no longer operates on its own special circuit with its own special rules, rather it is part of the mainstream financial markets. De-specialisation of specialist housing finance institutions is occurring throughout the world. It would occur in Britain regardless of European Community developments, but they are accelerating the process. In the longer term, it is probably the case that building societies will continue to de-specialise, and within ten or twenty years it is likely that the already blurred dividing line between banks and building societies will be firmly abolished. Some of the institutions which are now building societies might then be part of foreign owned banking institutions, or, indeed, they might be the parent of international banking groups. However, the fundamental point will remain, that is that retail banking in particular and mortgage finance in general are predominantly national markets.■