# Diversification in a Maturing Mortgage Market

by J. M. Blackburn

## INTRODUCTION

The topic of this article is how housing finance specialists can survive and adapt to meet wider market needs. To do this I need first to take you back to the origins of my own building society, the Halifax.

We were founded in 1853. In 1853 the town of Halifax was enjoying (if that's the right word) the sort of growth we see in third-world cities today—a sort of Sao Paulo of the South Pennines. We certainly had third-world problems in full measure: dreadful or non-existent sanitation; a high death rate from infectious diseases; and overcrowded homes averaging around six people in a two-room dwelling.

Charles Dickens visited Halifax in the 1840s and described it as "a dreadful place." Her Majesty's Sanitary Inspectors, however, said the key priorities were simply better housing and better sanitation. If these were improved, the town would become "an agreeable and healthful place."

Accordingly, our own founding fathers set themselves a very limited aim. That aim was to alleviate just one of the social problems that arose from rapid economic growth: bad housing. They restricted their scope to the town of Halifax. Only in our 10th year did we take the bold step of establishing an outpost a few kilometers away in Huddersfield. Only in the 1920s did we lift our eyes above the horizon and expand beyond the north of England. Only this year have we begun to lend outside the United Kingdom. Without this geographic diversification we would have stopped at the town boundary, and we would have grown little in real terms since the late 19th century.

J.M. Blackburn is Chief Executive of the Halifax Building Society, United Kingdom.

We went on to extend our services throughout the UK. As we diversified in geographic terms, we also moved into all sectors of the housing market. To fund our lending, we became the biggest recipients of personal savings in the country. From this solid base we have moved into other areas of financial services. Diversification is therefore not new for building societies in the UK. It has been happening in some shape or form ever since our earliest days.

Building societies, nevertheless, have very clear choices to make at this point in our history. In a sense, we are at a crossroads. In Britain, in our core markets, the job of creating a homeowning democracy is more or less complete, and we are being given clear signals by our government that it does not expect much more growth in homeownershp. Savings development would seem to be moving away from secure liquid investments. How, therefore, should we develop our undoubted strengths? What are the choices open to us?

## GROWTH OF MORTGAGE BUSINESS

Most people now agree that there will be a significant slowing in the rate of growth of mortgage business in the UK. The traditional mortgage business has matured. Mortgage lenders' balance sheets have grown very rapidly in money terms, but this will slow; so will the real rate of growth as measured either by inflation-adjusted cash figures or by the number of mortgages.

Until recently we heard optimistic noises from the UK government about owner-occupation at over 80%. Their cuts in help to the market, however, belie their words. There are many reasons why the rate of growth of homeownership will be much slower over the next generation. Even if the government is correct in its prediction of 1.5 million more homeowners over the next 10 years, as stated in the recent Housing White Paper, this would raise owner-occupation by only a percentage point or so.

Almost all the growth in owner-occupation in the '80s came from "Right to Buy" sales—the sale of municipal houses to their sitting tenants—when about 1.5 million homes were transferred from the public sector. In the 1980s owner-occupation grew by 11 percentage points from 56.5% to 67.5%. Nine percentage points of this growth came from Right to Buy sales.

Public sector renting has declined as Right to Buy sales increased. Private renting continued to decline through 1988, when the Housing

Act of that year resulted in some leveling off of this trend.

Now the best of the public sector rental stock has been transferred to owner-occupation. There will be little further growth in home-ownership from this source. Remaining tenants are old or receiving state benefits to pay the rents, or both.

We all know about the demographic trends which are set to reduce the number of households in the important first-time-buyer age range. Pressures to buy as early as possible or to go on moving up the housing ladder will be much weaker if, as we expect, capital gains from rising house prices are almost non-existent. Demand for good quality private rented homes could increase, and there is even a chance that supply could respond, reversing a decline in private renting apparent in the UK for much of the 20th century. As mortgage interest tax relief is cut, so fewer people will want to carry mortgage debt if they can possibly pay it off. Finally, low inflation means higher risks for lenders and borrowers; inflation no longer rescues us from bad lending decisions. So, we need bigger deposits and more pricing for risk, which will limit our ability to push the concept of home-ownership much further down market.

Given all these factors, the mortgage market of the future will be slower growing, and it will be riskier. It certainly won't be a "cash cow" if the market continues to be over supplied and price competition is as intense as we see it today. This does not mean that the mortgage market is unattractive, or that any group of players with massive strengths, like the specialist mortgage lenders, would want to exit. It does mean, however, that those who wish to grow and exploit their great strengths will have to find other markets.

## SAVINGS AND INVESTMENTS

What has been the real nature of our business as building societies? Essentially, we have bridged the gap between suppliers of finance and the mortgage borrower. We are very much in the retailing business. We share many of the preoccupations of other high street retailers: product quality, branding, service, minimizing distribution costs and so on. We are retailers with an excellent high street position and a strength of brand that can be and is being used for "direct" selling. There is massive scope just in personal financial services. First and foremost, the opportunities lie in mobilizing the nation's savings.

Our traditional strength is in risk-free, highly liquid retail savings. Despite the coming and going of National Savings, the UK government's retail savings arm, as a competitor, we will maintain our basic strength in this market.

But lower nominal rates for savers on secure investments, and real rates that are not very brilliant, push those savers towards bonds and equity-based funds.

UK equities have shown a long and reasonably steady uptrend. Certainly there is a danger that investors may no longer see the risks but, in a low-inflation environment with reasonable economic growth, we can expect a portfolio shift from secure liquid savings towards longer term, higher return risk investments.

Traditionally, building societies and to a large extent banks have approached this growing market as an off-balance-sheet source of income. We agree that success in this market doesn't require the move into bancassurance. Even as agents for insurance companies, banks and building societies are seen in their own right as legitimate providers of risk products. Fifty percent of the public in the UK would choose to buy life assurance from a building society against only 25% or so from a salesperson or broker.

But bancassurance takes us a step further. The Boston Consulting Group has defined it as "the most under-exploited business opportunity open to banks and building societies." The integration that comes with bancassurance brings greater efficiency through lower costs of administration.

We are quite certain that new players plus the enforced disclosure of commissions will make these markets much more openly competitive in the next few years. People will know much better just what they are buying, just what the costs are, and they will have a fairly good idea what the profit margin is and who gets it. The survivors in such a marketplace will be those with the best reputation, the best products, the most productive sales force and the lowest running costs. Bancassurers could stand the strain of any move away from front-end commission, something that would be a massive body-blow to smaller players in the independent financial adviser sector. We can pay the heavy costs of proper and thorough compliance. If we needed to, we could move further from commission-based to salary-based distribution.

Most large banks and building societies have made the bancassurance decision. Maybe this should cause consternation rather than satisfaction: herd instincts are dangerous. But the logic does stand up to severe questioning. Overall, if we get it right—and I don't rule out the possibility that some of us will get it wrong—the opportunities for banks and building societies are vastly better than those of the majority of smaller independent financial advisers or sales forces owned by insurance companies.

Bancassurance is a French word. Given its French origin and what we see among the French banks, it clearly does not just mean life, pensions and unit trusts. It means general insurance as well. Banks as well as building societies have a massive potential advantage in all the consumer insurance markets. We have, however, allowed the telephone-based direct players to encroach on these markets. Do not underestimate the abilities of these new players: they are efficient and they are price-competitive. In the UK they have gained a substantial share in some markets. But their market share gains arise not so much from the use of the telephone to deliver the service as from the gaping holes we left in our armor. First, our margins were probably too wide. Second, our administration was not brilliant. Finally, we put far too little pressure on the insurance companies to segment the market, both property and contents. Cross-subsidization left the classic opportunity for a new market entrant to come in and cream off the low-risk business. I believe those days are over. We can segment, we can price competitively and we can deliver the service efficiently through different channels to different customer groups. We can expand the range of personal insurance products we offer. From now on there will be no easy gains for "direct" players in the market.

### BUILDING STRENGTHS IN MONEY TRANSMISSION

A whole range of personal sector savings, investment and insurance products—some on-balance-sheet, some off—will be key to future development. But money transmission is another new market for building societies. Current accounts used to be the mainstay of the clearing banks, providing a cheap source of deposits. More than this, they provided an important pool of potential customers for other financial services. In many respects the banks' large branch networks developed to support the growth of current account business.

But current accounts are costly to operate, especially when interest rates are low. Even if someone breaks ranks and starts charging for current accounts in credit, the business is no money spinner!

Why are more and more players attracted to such an unprofitable market? The answer must lie in cross-selling opportunities. The current account which receives salary credits is the individual's key financial relationship; it is certainly the most active. Properly monitored, it presents the bank or building society with a mass of information on the opportunities and risks which that customer presents. It can be the foundation of multiple product relationships.

This is an area where size is pretty well essential, especially if there is any intention of trying to use 1990s rather than 1960s technology to improve the efficiency of clearing. But new market entrants have to accept that growing market share is painfully slow. If we believed everything we read in the newspapers, attracting current accounts from millions of disgruntled bank customers would be like taking candy from a baby. Unfortunately, it isn't like that. We have to fight for market share, and only the strongest, best-resourced and most efficient will win.

### DIVERSIFYING OUR ASSETS

What about the asset side of our main balance sheet? Housing finance institutions generally have been asset-driven. Will this change? Will we be much more concerned to generate fee and commission income? Could we even find it hard to make use of ordinary savings inflow and move to offering money market funds or a gilts investment service?

We are certainly seeing the banks move away from asset growth towards off-balance-sheet income. Asset growth, especially when those assets prove to be of dubious quality, is now much less attractive. Only two years ago the talk was of a capital famine among the banks in the UK. Now it is a feast and at least one major bank has repurchased its own shares to reduce its capital. What about the building societies? Will our asset growth grind to a halt? I can see several important growth areas.

First, there is the rest of housing. Population growth and especially growth in the number of households in the UK will still be a feature of the next 10–20 years. If owner-occupation is not to grow much further, then the country has to finance housing for rent. This can be public sector or private sector. In both these sectors we see a UK government much more intent to reduce today's capital commitments than worry about future revenue implications. Whatever the reasons for this, and even if there is a change of government over the next year or so, the demands on the private sector to finance social housing now and maybe private rented housing in the future could be very substantial. This alone could generate asset growth sufficient to compensate for the slower expansion of owner-occupation.

Beyond this we have substantial scope for expanding personal unsecured lending, plus secured lending for home improvements and major durables. We can develop the market for education-related loans. It is quite clear that by the next century virtually all further education in the UK will have to be privately financed. So will much medical treatment, mostly by private insurance but some through loans. We can help finance people through their years of dependency. A future state will not support expensive nursing home care other than on a strictly means-tested basis. This means that older people will need a mechanism to release the savings they have built up in their homes—reverse mortgages, as they are called in the United States, or Home Income Plans here in the UK. These are a clear option for building societies. Since it means that less wealth is recycled to younger generations, so our scope for traditional mortgage lending is enhanced.

Our banking colleagues will no doubt be interested in our ambitions in the world of corporate lending. Building societies have some experience of commercial secured lending. We have, however, no experience in corporate unsecured lending to "blue chip" companies; and in experience terms, we are light years from lending to small businesses. The pressures are on us to finance sole traders and the self-employed, but this market, which seems to generate more emotion than profit, will for some time remain with the traditional banks.

All this means we still see fairly strong asset growth, more diverse but still concentrated in the personal sector. I must add that certainly into the next millennium this will be mainly UK-based. I stressed before that we were retailers, and, with a few notable exceptions, the banks themselves have proved the difficulty in exporting retail banking overseas.

### INDUSTRY STRUCTURE AND SIZE

When I talked about the mortgage market, I touched on the question of excess capacity. How it might be eliminated is a highly topical question.

In the UK banking world, excess capacity has been created as much by greater efficiency on the supply side as by falling demand. At long last, technology began to fulfil its promises in the 1980s and generate real productivity improvements. At last paper-based transactions started to give way to automated payments and plastic cards. The ATM came into its own. Around two-thirds of all cash withdrawals from the banking and building society system are now through ATMs.

The major impact of these changes has been seen in branch closures, with the banks reducing networks by more than 15% and building societies by more than 10%. UK banks can still rationalize further because of the branch overlaps which remain following the 1960s mergers.

What about building societies? Here there are problems. The new Halifax has a network of over 1,000 branches serving a customer base of approximately 15 million. We also want to develop many more product relationships with that customer base. Despite our increased network following our recent merger with the Leeds, we needed the extra branches.

The gradual process of merger among smaller societies will reduce the overall network. However, the only real prospect of major rationalization would come if there were more mergers among the less efficient of the top 10 or 20 societies. Mergers gradually allow capacity to be adjusted to demand in the mortgage market, while giving the size and scope for the combined business to build its strength in other areas.

In addition, some societies, rather than seeking merger, may find more attractive an agreed deal with the right bank or insurance company as a partner. As far as the ultimate constitutional form is concerned, this must be a pragmatic decision, especially for the bigger societies. Mutuality is simple and has been very effective as a form of business for societies in the UK. Society members like it and trust it even if competitors do not. Larger societies, however, are now very diverse in their range of activities, and in many new business areas there is no member relationship. Members are, of course, becoming more aware of their "value" relationship in their ownership of societies' reserves and may increasingly put pressure on societies to realize this value.

What about our own plans? We certainly are proposing a plc [public limited company] conversion, but this isn't a road-to-Damascus conversion for the Halifax. I do not deride the mutual form or preach the unquestionable superiority of plc's. The arguments are even now quite finely balanced. The weight of arguments as far as we are concerned, however, has finally tipped the balance in favor of conversion.

We believe that the plc form will give us important funding advantages as a bank, as well as freeing us from the constraints of an increasingly outdated piece of legislation. It will release value for members and will separate the present confused customer/owner relationship into customer and equity shareholder relationships. We believe that our customer-friendly image can be sustained throughout, and indeed extended to the many new areas where customers would not in any event have been society members. Certainly, we will have to pay dividends, but maybe rightly so; and maybe this is something we could not long escape as a building society. This has not been an easy decision. Despite it being the focus of attention today, however, it is in fact strategically far less important than the route we choose in the financial services market.

### BUILDING SOCIETIES: THE WAY FORWARD?

Constitution is a means to an end, not an end in itself.

The business strategies adopted by societies or former societies are much more interesting. Here we have to distinguish between large and small, leaving the medium-sized 20 or so societies awkwardly poised in between. Small societies do have their strengths—market niche and friendly service—but they miss out on the key strengths which will be important in the next decade. They face big problems: an ever-increasing regulatory burden, limited wholesale funding skills or scope, less access to the latest technology and ever-increasing customer expectations. A few will survive, giving excellent service in local markets, but most must seek to merge or be absorbed by a bank or insurance company.

What of the top 10 housing finance specialists of the future? The main tasks will be to retain our strengths, our public esteem, our cost-effective lead in distribution networks and our low costs. The drive for greater efficiency must continue. The banks have a similar drive, and we must retain the gap which gives us our competitive edge. Priorities for the top 10 will diverge, sometimes significantly. But I would expect all of the following to be "on the agenda" for my main housing finance competitors, as indeed they are for the Halifax.

- First, mortgage lending continuing as the core business, but accepting narrower margins, slower balance sheet growth, more attention to containing risk and segmenting the market with a stronger focus on customer service and cost management.

- Second, a steady diversification into other forms of secured lending.

- Third, for those of us who want to be serious competitors to the banks, a slow but steady expansion of money transmission and consumer credit.

- Fourth, an active development of other income sources, mainly through the sale of life assurance and risk investment products, and general insurance.

- Finally, and this could be key, a much more variable pattern of distribution, with a major investment in direct telephone-based service plus other multiple channels to suit different products and different customer needs.

## CONCLUSION

What conclusions can we draw from all this? First, that we have a very healthy housing finance industry despite the worst recession in living memory. The recession has reinforced the traditional lenders' strengths by forcing some of the new players who entered the mortgage market in the 1980s to cut their losses and leave the market. We are building our franchise and our strengths in the wider personal finance market. That market will grow strongly over the next generation.

The leading high street names in what was the building society world are extremely well-placed to dominate UK personal finance. At the same time, we can maintain our great ethos and our strong and close relationships with the British public. We have diversified, but into our strengths in personal financial services. This is our knitting, and we will stick to it.