

The development of the building societies sector in the 1980s

Over the past decade there have been radical changes in the conditions building societies face in their traditional mortgage and savings markets. This article⁽¹⁾ reviews societies' behaviour prior to the 1980s and considers the principal external forces affecting the market in the 1980s, the nature of the regulatory response and the resulting changes in the main components of their balance sheets. A comparison is made of the interest margins earned by banks and building societies. The article goes on to examine changes in the structure of the building society industry. Finally, performance during 1990 is considered.

Overview

Until the early 1980s the building societies collectively enjoyed a near monopoly over mortgage provision and, since the savings market was heavily segmented, they were to a considerable extent insulated from competition in the collection of retail deposits. Competition between societies was restricted through cartel arrangements; in particular, the Building Societies Association (BSA) recommended interest rates which all the larger societies followed. These were not adjusted frequently nor fully to changing conditions, so that rates were often below market clearing levels. As mutual institutions, societies tended not to maximise profits, but rather attempted to reconcile the conflicting demands of borrowers for low rates and savers for high rates by keeping rates fairly steady. Moreover, changing interest rates was costly since they had to notify all of their customers by post in advance of such actions.⁽²⁾ An important and frequent consequence of this behaviour was the emergence of excess demand, with borrowers having to queue for mortgages. This situation was sustainable because there was little competition to societies in the mortgage market.

In the 1980s the market environment altered radically. The crucial development affecting the mortgage market was the relaxation of controls on banks' balance sheet expansion. In the 1970s, the supplementary special deposits scheme (the 'corset') restricted banks' ability to lend. The removal of exchange controls in October 1979 made such controls easy to bypass by channelling activity abroad and the 'corset' was abolished in mid-1980. The banks responded by expanding their business in the mortgage market, which was seen as profitable and low risk. This occurred at a time when the recession meant that corporate lending was risky and, chastened by the LDC debt problems, the banks were looking for safer ways to boost margins and strengthen or diversify their balance sheets.

These developments also helped to stimulate competition in the retail savings market. Traditionally banks offered

transactions accounts (which, until recently, have not paid interest and in certain circumstances have charged for transactions) and liquid savings accounts (usually requiring seven days notice of withdrawal). Building societies offered only savings accounts, although they started to offer term accounts in the early 1970s.⁽³⁾ Overall, while the societies succeeded in expanding their market share, the banks' share remained broadly static; a large part of their funds was raised from the wholesale markets. In the 1980s this situation changed; the retail savings market became less segmented as the banks sought to make more use of their distributive outlets. One important factor underlying their decision was the need to justify the cost of their extensive branch networks. Moreover, it was realised that developing retail funding could introduce new customers and lift sales of insurance, pension, and mortgage products. Furthermore, the banks wanted to be able to obtain funds easily from both the wholesale and retail markets so as to have a strategic choice in their funding policies; a long-term presence was, and continues to be, necessary in order to participate in either market. Finally, higher nominal interest rates had made depositors less willing to hold the non-interest-bearing current accounts that were banks' main traditional retail products. Indeed, one of the main consequences of the greater competition in the deposit market was the introduction of interest paying transactions accounts in 1985.

Increased competition also led to the demise of the recommended rates system. The first serious strains emerged during the 1970s with a strengthening of the competition between societies for retail deposits; individual institutions had started to offer attractive term share and short notice accounts outside the recommended rates system. The more active participation of the banks in the market added to existing pressures. In September 1981, the BSA decided it would recommend only ordinary share and base mortgage rates and then announced in October 1983 (after the Abbey National announced its intention to withdraw from the cartel) that it would only advise, rather than recommend, rates. From November 1984, the BSA merely

(1) Written by T S Callen and J W Lomax in the Bank's Economics Division.

(2) Administration costs have fallen in real terms since the 1970s with, for example, the adoption of annual review schemes by some societies; these determine the level of borrowers' payments once a year, even though the level of the mortgage interest rate itself may vary throughout the year.

(3) Term accounts were actually introduced by some societies in the late 1950s, but only came into prominence during the 1970s.

co-ordinated the timing of interest rate changes and indicated their approximate magnitude; in 1986 even this limited role was abandoned.

In the context of these developments, the building societies faced a key disadvantage in that the banks were better able to compete in the traditional business of the building societies than were the building societies in the business of the banks. Under the Building Societies Act (1962), societies could lend only on mortgage secured on freehold or leasehold property. Their remaining assets had either to be fixed assets (eg their offices) or liquid assets held in a range of closely defined government (and government-backed) securities and bank deposits. Their funding came from retail savings. In contrast to the societies' restricted position, banks could offer money transmission facilities,⁽¹⁾ combined with savings accounts. Equally, mortgage loans could be sold in conjunction with other products such as estate agency services, unsecured loans and insurance services.

Additionally, they were less restricted in their funding. As a consequence, it became increasingly clear that changes in building society behaviour and further deregulation would be required if they were to be able to compete effectively.

Changes in tax arrangements in 1983, enabling interest to be paid gross, rather than net of tax, significantly improved societies' access to the wholesale markets. They rapidly made increased use of such funds. Indeed, to a degree, building society expansion into the banks' liability markets paralleled the banks' penetration of building societies' traditional asset market (mortgages).

More radical change was introduced in the The Building Societies Act (1986),⁽²⁾ which came into effect on 1 January 1987 and provided a new legislative framework for building societies. It allowed for a progressive deregulation of the products which societies could offer on both the asset and liability sides of their balance sheet, and the range of other activities which they could undertake. However, certain absolute limits to deregulation were set, so that building societies would retain their distinctive nature. This was defined (in Part 1, Section 1 (4) (c) of the Act) as follows;

'The principal purpose of building societies remains that of raising, primarily from their members, funds for making advances to members secured upon land for their residential use.'

Without further primary legislation, fundamental changes to building societies' powers cannot be implemented, although

important secondary legislation has been introduced in response to changes in market conditions. Equally, procedures were laid down in the Act so that societies wishing to operate outside the limits set could convert to public limited companies, although this would involve the loss of mutual status and require authorisation as a bank. In general, the Act facilitated an improved response by the societies to the increased competition which had emerged in the savings and mortgage markets. As such, it stands in contrast to the situation in the United States where legislation liberalising the behaviour of the savings and loan associations (broadly the equivalent of British building societies) exerted a perverse effect on industry performance.⁽³⁾ Nevertheless, recently concerns have been expressed that the constraints embodied in the Act could severely restrict societies in the future.⁽⁴⁾

Balance sheet developments

Increased competition in the 1980s has led to fundamental changes on both sides of building society balance sheets. In particular, there has been much greater reliance on prices as a means of clearing markets. Correspondingly, there has been less resort to quantitative rationing. A further aspect has been the greatly expanded range of savings, wholesale and mortgage instruments available and the consequent enhancement of consumer choice. Particularly on the retail side, an important motivation for innovation on the part of societies has been a desire to differentiate products for commercial advantage.

Liabilities

Banks and building societies have both traditionally funded their lending from the retail deposit market. The societies did not gain access to the wholesale markets on a large scale until 1983, whereas the banks, not being similarly restricted by legislation, developed their liability management techniques in the wholesale markets in the 1970s, and became less reliant on retail funding. In recent years the wholesale markets have at times provided a cheaper source of funds (especially at the margin) than the retail deposit market. Access to wholesale funds also provided societies with more flexibility.

(i) Retail funding

During the 1970s, the building societies made inroads into the market for personal sector financial savings,⁽⁵⁾ at the expense of equities and national savings, while the banks maintained a near constant market share. Although the societies gained a further proportion of the market in the

(1) Since their accounts could not be overdrawn, societies were unable to offer cheque guarantee cards, which made it very difficult for them to market such products.

(2) See *Guide to the Building Societies Act 1986*, BSA, August 1986, for a summary and analysis of the Act.

(3) The existence of deposit insurance encouraged insolvent institutions (a significant part of the industry—see Brumbaugh, R D, *Thriffs under Siege*, Ballinger, 1988)—to use new opportunities to take excessive risks. In such a situation, the financial gains resulting from a successful gamble accrued to owners and managers, whereas the deposit insurer (Federal Savings and Loan Insurance Corporation) bore the loss if the gamble failed.

(4) For example, in a briefing paper to its members the BSA has said: 'While the present legislation is inadequate in some respects, the problems are, at this stage, irritations . . . in the longer term these irritants collectively will be more damaging in their impact.'

(5) Financial savings are here defined to include deposits with banks, building societies and national savings and holdings of equities and gilts (excluding equity in life assurance companies and pension funds).

Table A
Financial assets of the personal sector
 £ millions, percentage shares in italics

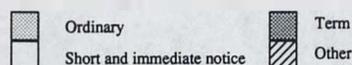
| | 1975 | 1980 | 1985 | 1989 Q1 |
|------------------------------------------------|-----------------------|-----------------------|------------------------|------------------------|
| Bank deposits | 19,206 <i>23.7</i> | 36,598 <i>24.1</i> | 61,488 <i>20.9</i> | 98,580 <i>20.5</i> |
| National savings | 8034 <i>9.9</i> | 12244 <i>8.1</i> | 30638 <i>10.4</i> | 36313 <i>7.6</i> |
| Building societies shares and deposits | 22,529 <i>27.8</i> | 49,669 <i>32.7</i> | 103,787 <i>35.2</i> | 154,036 <i>32.1</i> |
| Gilts | 7,205 <i>8.9</i> | 13,437 <i>8.8</i> | 21,801 <i>7.4</i> | 31,646 <i>6.6</i> |
| Unit trusts and ordinary and preference shares | 24,184 <i>29.8</i> | 40,171 <i>26.4</i> | 76,869 <i>26.1</i> | 159,799 <i>33.3</i> |

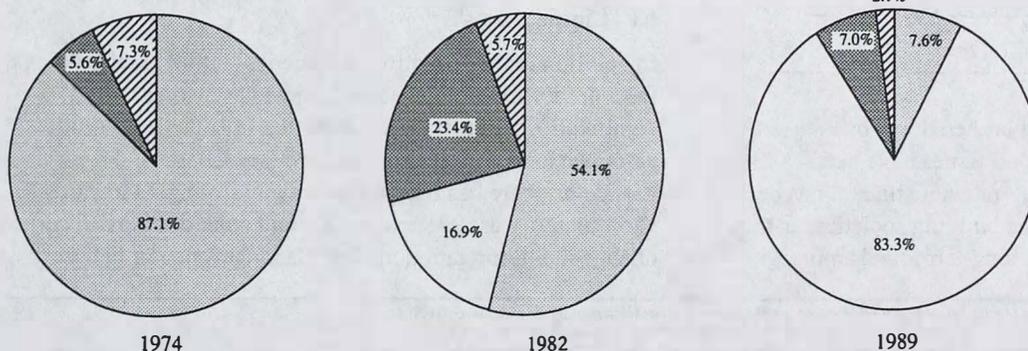
Source: *Financial Statistics*, Table 14.5.

early 1980s, while the banks lost share, the banks proved more successful in maintaining their position when the personal sector's interest in equities revived in the second half of the decade.⁽¹⁾ A number of factors underlay this revival. These included changes in the distribution of income, the introduction of personal equity plans, the rise of unit trust investment, the number of privatisation issues and the growth in equity prices. The market share of national savings increased slightly in the early 1980s, when it was actively promoted by the government and targets were set for the contribution of national savings to the financing of the PSBR, but declined later in the decade, as did the share of gilts.

The retail deposit market has become increasingly innovative with a wide range of products now offered. One of the main manifestations of this trend was the introduction of short-notice accounts in 1980; these had a shorter maturity than the term accounts and the characteristic that the early withdrawal of interest incurred an interest penalty. They filled the gap between term accounts and ordinary accounts. Societies also introduced instant-access accounts, which were similar to ordinary accounts, but required a minimum investment. Chart 1 illustrates the changing composition of building society retail accounts. While in the

Chart 1
Composition of building society retail accounts





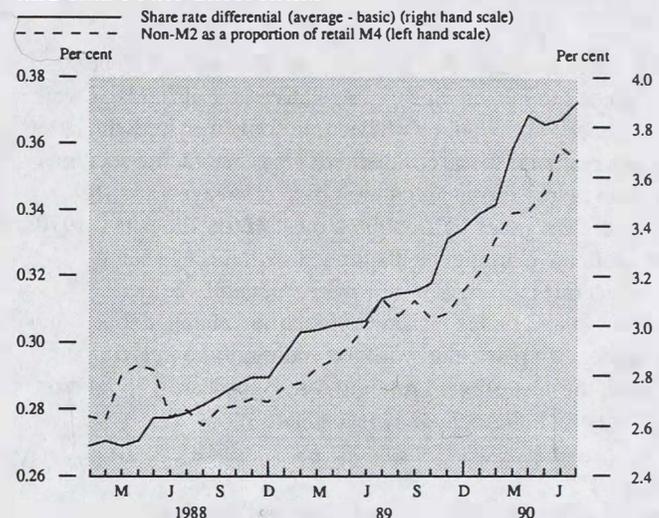
(1) The conversion of the Abbey National to plc status in July 1989 took it out of the building society and into the bank statistics. This affected stock data at the end of the second quarter and flow data from the beginning of the third quarter. See 'Statistical consequences of the conversion of Abbey National Building Society to a public limited company', in the *August 1989 Bulletin*. Because of these problems, the most recent figures cited in Table A refer to the first quarter of 1989; bank and building society shares have remained broadly flat since then.

(2) Generally also the rate paid on other balances under £500.

early 1970s funds held in ordinary accounts accounted for nearly 90% of all building society retail deposits, by 1989 this proportion had declined to less than 8%. Short-notice and instant-access accounts are now the most important, having grown rapidly since their introduction.

Within the retail market as a whole, despite strong competition between the societies and banks, some new signs of segmentation have emerged, with societies generally concentrating on obtaining the longer-term and larger balances. This has increased the cost of their retail funds, as

Chart 2
Building societies: non-M2 shares and deposits as a proportion of their retail M4 shares and deposits, and share rate differential



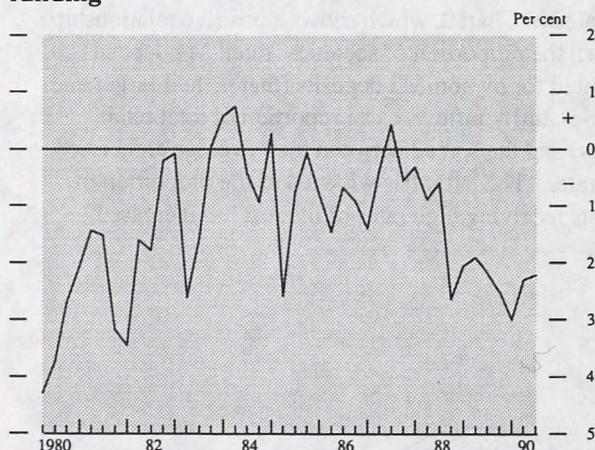
illustrated in Chart 2, which shows a positive relationship between the proportion of societies' retail M4 deposits accounted for by non-M2 deposits (that is their larger and longer-maturity inflows as a proportion of total retail inflows) and the spread between their average and basic⁽²⁾ share rates. The latter has widened as the proportion of deposits receiving high rates of interest has increased.

(ii) Wholesale funding

As noted above, after 1983 changes in tax arrangements greatly enhanced societies' ability to tap the wholesale markets. Limits were, however, introduced in the 1986 Act; societies were to obtain no more than 20% of their total funding requirement from money-market sources, although this could be raised to 40% by statutory instrument. Prudential regulation is used to ensure that there are no sharp swings in societies' funding. With effect from 1 January 1988, the wholesale funding limit was raised to its maximum ceiling, as the initial setting was acting as a constraint on some societies competing effectively in the mortgage market. At present, societies' aggregate ratio stands at 18.2% and in 1989 none of the fifteen largest societies had a ratio exceeding 24%.

The increased use of money-market instruments can be attributed to movements in the relative cost of funds as well as changes in tax policy. Indeed, in some measure, the latter was a response to the competitive pressures facing societies and an increased desire on their part to have recourse to wholesale sources. Throughout most of the 1960s and 1970s the collective arrangements for setting building society interest rates meant that they were frequently below money-market rates. Rising competition changed this situation. In particular, with the ending of the interest rate cartel, the cost of retail funding rose significantly in relation to that of wholesale money (see Chart 3).⁽¹⁾

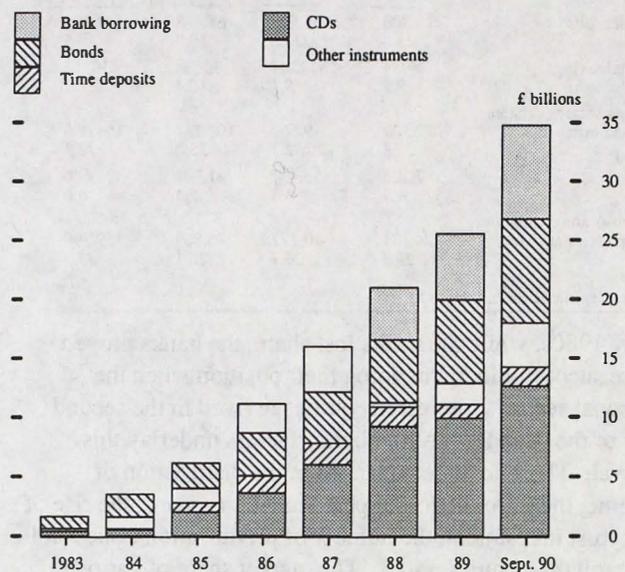
Chart 3
Cost differential between retail and wholesale funding^(a)



(a) Average gross retail deposit rate minus 3-month Libor.

Chart 4 shows wholesale funding broken down by instrument, and as can be seen bond issues have been popular. The eurosterling floating-rate note market has been a particularly attractive one for the building societies, as they have been able to use it to obtain long-term funds more

Chart 4
Components of building society wholesale funding (levels)



cheaply than in any other form. The ability to undertake swap transactions has meant that funds can be raised in the fixed-rate bond and the non-sterling eurobond markets and swapped into floating-rate sterling liabilities (funds raised in foreign currency are normally immediately swapped into sterling). The largest societies now have ratings with the major credit rating agencies⁽²⁾ and this allows them access to cheaper funding and a greater variety of markets.

Access to the wholesale markets has meant that liquidity management has become more flexible. Under the cartel, when interest rates were rising, deposit rates lagged behind other rates so that societies became less competitive and retail inflows consequently weakened. Liquidity was then run down to help fund lending. The opposite occurred when interest rates were falling. Ability to use the wholesale markets has meant that a shortfall in retail inflows can be made up by recourse to the wholesale markets, consequently a smaller liquidity cushion is necessary. Chart 5 shows the associated trend decline in societies' liquidity ratio.⁽³⁾

Assets**(i) Liquid assets⁽⁴⁾**

In addition to the reduction in societies' liquid asset holdings (as a proportion of total assets), there has also been a significant change in the composition of societies' liquid asset portfolio over the past decade (see Chart 6). In particular, there has been a move away from gilts towards short maturity assets such as CDs and bank deposits. The change in interpretation by the Inland Revenue in February

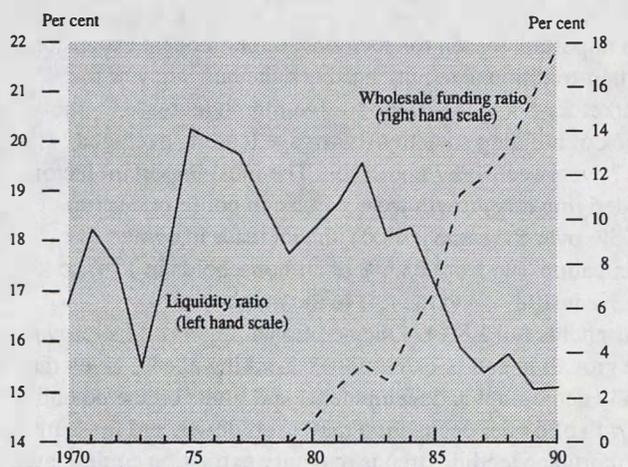
(1) This chart uses the average deposit rate as the cost of retail funding. It is often argued that the appropriate rate for measuring the marginal cost of retail funds is the maximum retail deposit rate. If this is used then wholesale funding has been cheaper than retail for most of the 1980s. See Drake, L and Llewellyn, D 'Building Society Profitability Analysis: A Pilot Study of the Halifax Building Society 1970-86', Loughborough University Banking Centre Research Monograph No.2.

(2) Moody's rate senior debt offered by the Halifax as Aa1; other societies listed are rated at Aa3.

(3) The liquidity ratio is defined as liquid assets (excluding holdings of building society CDs) as a proportion of total assets (excluding holdings of building society CDs).

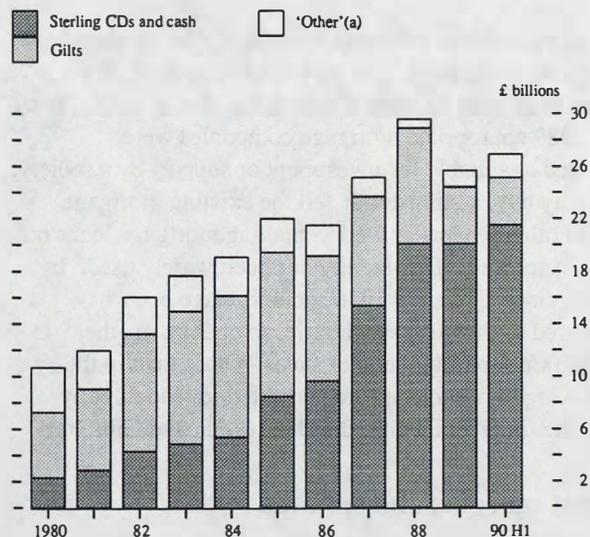
(4) Under the 1986 Act, there is no minimum requirement on societies' holdings of liquid assets (although there is a maximum of 33.1% of total assets), but they must keep sufficient liquidity to be able to meet liabilities as they arise. Discussions are held between the Building Societies Commission and the individual societies to determine appropriate holdings.

Chart 5
Wholesale funding and liquidity ratio



1984 of the law regarding capital gains made by building societies on gilts reduced the incentive to hold these assets. Prior to this, such gains had in most circumstances been tax free. Under the new interpretation, the capital gains societies made on the disposal of gilts were to be taxed at the normal corporate tax rate. Societies have also followed a policy of reducing the maturity profile of their liquid asset portfolio for other reasons. The inverted yield curve which has prevailed over the past two years, coupled with the increased volatility of retail inflows, has provided significant incentives to hold short rather than long dated assets. Societies have managed their liquid asset portfolios more actively as they have realised that this can make an important contribution to overall profitability.

Chart 6
Composition of liquid assets (levels)



(a) 'Other' includes local authority debt, sterling Treasury bills and certificates of tax deposits.

(ii) Commercial assets

During the 1970s, the mortgage market was dominated by the building societies (they accounted for some 80% of the

stock of mortgage lending). Local authorities took about half of the remainder. In addition, insurance companies offered some endowment mortgages funded both from their own resources and from building society allocations. Equally, the banks undertook a small amount of mortgage lending (in both 1972 and 1973 they accounted for 13% of the flow).

In the 1980s, non-building-society institutions began to participate more extensively in the mortgage market. With the abolition of controls on their lending, the banks found it an attractive avenue for pursuing their new freedoms. Having been involved in the provision of bridging finance and top-up loans, they found it relatively easy to expand into mortgage loans. Moreover, as the abolition of the building societies' interest rate cartel led to mortgage rates moving more in line with money-market interest rates and, in general, being above them (Chart 7),⁽¹⁾ specialised mortgage lenders, funded exclusively from wholesale sources, were able to enter the mortgage market. For both the banks and specialised lenders entry was initially facilitated by the existence of excess demand.⁽²⁾

Chart 7
Building society average mortgage and money-market rates

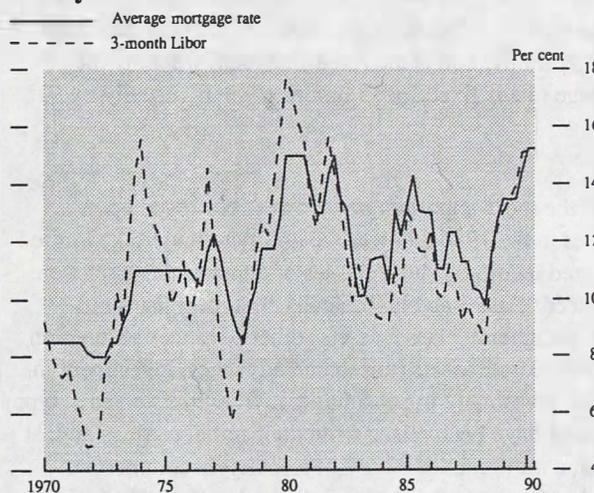
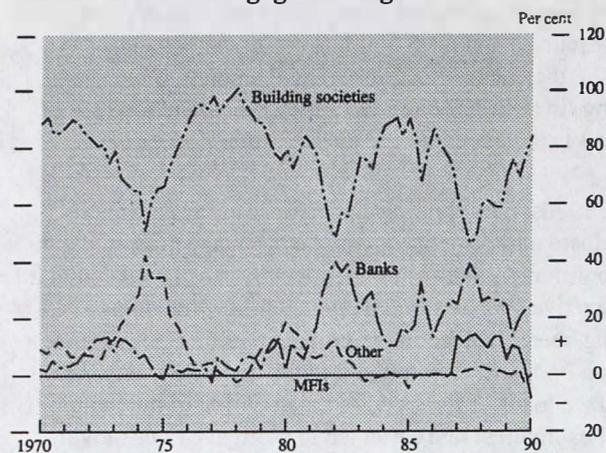


Chart 8 shows the percentage of the net flow of mortgage lending accounted for by the three major types of lender. Two periods are of particular interest: the beginning of 1981 when banks entered the market and increased their market share rapidly, to a peak of around 40% at the beginning of 1982; and from mid-1986 to end-1987 when wholesale money was cheaper than retail funds and societies were constrained by the 20% wholesale funding limit. The banks and the new lenders increased their market share to over 50% in the third and fourth quarters of 1987.

Although, in general, innovations in the range of mortgage products offered have been less marked than those on the funding side, some developments have occurred recently,

(1) These are classified as Miscellaneous Financial Institutions (MFIs) in the official statistics (see, for example, Table 9.4 in *Financial Statistics*).
 (2) Since both of the new groups of lenders can be characterised as intermittent participants who enter the market when profit opportunities arise, it could be argued that the mortgage market is now close to being perfectly contestable (see Baumol, W, Panzar, J and Willig, R, *Contestable markets and the theory of industry structure*, Harcourt Brace Jovanovich, 1982). In the pure form of such a market there are no barriers to entry and prices are held down to the levels of marginal cost by the threat of potential entry.

Chart 8
Shares of new mortgage lending



not least as societies have sought to encourage buyers in the current depressed housing market. Many societies now offer temporary discounts on larger loans and those to first-time buyers. The rationale for such behaviour would seem to lie in the existence of switching costs. To the extent that these act as a constraint on customers remortgaging with another institution, lending becomes more profitable once discounts terminate. Another recently developed product is the 'low-start' mortgage on which repayments are scheduled so that the burden is lighter in the early years of the mortgage. A further innovation is the fixed-rate loan, whereby the mortgage rate is fixed for a number of years (usually two or three).

One of the most important new powers bestowed upon societies in the 1986 Act was the ability to undertake limited unsecured lending. Three classes of commercial asset were introduced: class 1 assets (basically first mortgages to owner-occupiers), class 2 assets (other advances secured on land) and class 3 assets (unsecured advances, investment in land and investment in subsidiaries). The limits on each type of lending have been raised from their initial settings and, at present, a minimum of 82.5% of a society's commercial assets have to be in the form of class 1 lending. Up to 7.5% of commercial assets can be in the form of class 3 lending (although only societies with commercial assets exceeding £100 million can make any unsecured loans), with such loans to any one individual limited to £10,000. The introduction of class 3 lending gave societies the opportunity to issue credit cards, provide money transaction accounts with overdraft facilities and to provide unsecured loans for non-housing-related purposes (previously these had to be secured).⁽¹⁾ As regards non-traditional business, societies are generally currently well below the prescribed ceilings. This is true both in aggregate, and for individual institutions. Building societies' class 2 lending, while doubling in the last

year, still represents only some 3% of total commercial assets. Class 3 assets account for only 1.5% of the total.

An important reason for societies' rather modest expansion of non-traditional activity has been the buoyancy of the market for home loans; the twelve-month increase in the stock of building societies' mortgage lending averaged 15.7% between 1987 and 1989. The most important factors underlying this growth were the rise in house prices (up 58.5% over the same period), the increase in owner occupation, (up from 63.6% of all households in 1987 to 66.3% in 1989), and the rise in the number of new households (up 1.8%). One additional important factor was the growth in equity extraction.⁽²⁾ Looking ahead, given that likely demographic developments and limits on the potential growth of owner occupation may exert downward pressure on mortgage lending, trends in equity extraction could play a significant part in determining the future size of the market. It is possible that, to the extent that the rate of growth of the mortgage market slows, societies will undertake more class 3 business.

New powers

Under the Act, and subsequent amendments, societies' powers have been greatly expanded although again certain restrictions on behaviour were laid down. In particular, they are permitted to provide only services which fall into the categories of 'financial services' or those 'relating to land'. Among the former are money transmission, banking services for individuals, investment services for individuals and trusteeship and insurance, while the latter include residential development, holding land and property, estate agency and conveyancing.

There is, in addition, a provision in the Act for designating bodies with wider powers, in which societies may invest. This has been used on several occasions. For example, from 1 July 1989 appropriate mortgage companies were designated as suitable for investment or support by a society. These may buy, administer or sell the existing mortgage books of other lenders as well as making mortgage loans on their own account. This facility has been widely used. In addition, since 1 January 1988 societies have been empowered to establish subsidiaries to operate in other European Community member states. Other than in the United Kingdom, societies are permitted to lend directly only in the Channel Islands, the Isle of Man and Gibraltar.

Interest margins and spreads

Interest rate margins and spreads are broad measures of financial institutions' profitability (in addition to more conventional indicators such as return on capital and return

(1) The limits on class 2 and class 3 lending are to be further raised so that by the beginning of 1993 they will be able to account for 25% of commercial assets, with a limit on class 3 assets of 15%. These changes have allowed societies to diversify away from traditional mortgage business in response to market conditions and have enabled them to plan these new business ventures in advance.

(2) Equity extraction can be defined as the difference between the net increase in the stock of house purchase loans and the private sector's net expenditure on housing. It arises mainly from the actions of last-time sellers leaving the housing market but also from those of existing owner occupiers borrowing in order to run down their housing equity or trading down. See Holmans, A E, (1986), 'Flow of funds associated with house purchase for owner-occupation in the United Kingdom 1977-84 and equity withdrawal from house purchase finance', Government Economic Service Working Paper No. 92. Also 'The housing finance market: recent growth in perspective' in the March 1985 *Bulletin*, pages 80-91.

on assets), although important contributions to income now also come from other sources. Furthermore, they provide an approximate indicator of efficiency in intermediation. That said, comparisons of bank and building society interest rate margins⁽¹⁾ are significantly hindered by differing funding and lending structures. A much higher percentage of bank lending is on an unsecured basis, whereas virtually all building society lending is secured. The former generally carries a higher risk and consequently a higher rate is charged to compensate. Banks also have higher average costs because of the more diverse range of services they offer.

Table B
Interest margins

| | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|-----------------------|------|------|------|------|------|------|
| Banks(a) | 5.62 | 5.67 | 5.59 | 5.50 | 5.00 | 4.70 |
| Building societies(b) | 1.69 | 1.89 | 1.90 | 1.96 | 2.03 | 2.11 |

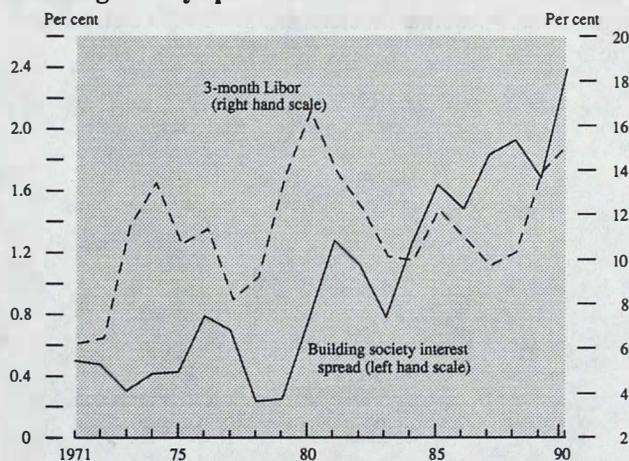
(a) Average of the four major clearing banks. The banks' interest margins are published in their annual reports. The average for the four major clearing banks is published by the Bank of England in the Annual report under the Banking Act.

(b) Average of the ten largest building societies calculated from data in the Building Societies Yearbook, 1990 published by Franey and Co.

These caveats should be borne firmly in mind when considering the figures reported in Table B. In particular it is not surprising that the banks' domestic interest margin exceeds that of the building societies. An additional feature is that since 1987 bank margins have shown a more marked decline; this is largely attributable to a reduction in the endowment effect.⁽²⁾

An estimate of societies' interest spread is shown in Chart 9. This is computed as the difference (in percentage points) between their average lending rate and the average funding rate. It is assumed that all society lending is made at the prevailing mortgage rate and that the cost of funding is a weighted average of retail (average gross share rate) and wholesale (assumed to be 3-month Libor)⁽³⁾ funding costs. It

Chart 9
Building society spread and 3-month Libor



(1) Defined as net interest income as a percentage of average total assets.

(2) A benefit arising from the existence of zero interest current accounts which can be deployed at market rates exceeding the costs of running such accounts.

(3) There are obviously problems with this assumption. Large societies are likely to be able to obtain funds at a lower rate than smaller ones and in some cases at below Libor. Swaps can also be used to reduce funding costs. Also, fixed-rate issues are likely to be above or below Libor depending on the recent history of interest rates.

(4) See Drake and Llewellyn, 'Building Society Profitability Analysis', for a similar pattern in the spread of the Halifax Building Society up to 1986.

(5) Annual Report of the Building Societies Commission 1989-90.

(6) An alternative view is that the movement to conversion has only been attenuated by poor market conditions. When these improve conversions could again be pursued.

is clear that both societies' average spread and their interest margin have widened over recent years. This tends to suggest an increase in profitability. On the other hand, some of their newer accounts carry services (such as money transmission) which have costs.⁽⁴⁾ It is difficult to calculate a comparable retail spread for the banks since the data are insufficiently disaggregated. However, where they provide an equivalent service, spreads are likely to be similar.

Structure of the industry

The building society industry has undergone a period of structural change, although this has been less far-reaching than might have been expected given the nature and extent of the outside pressures impinging on their principal markets. There has been an increase in concentration, with the largest ten societies accounting for 79% of total assets in 1989 compared with 71% in 1980.⁽⁵⁾ Moreover, the number of societies more than halved between 1980 and 1989, largely owing to extensive intra-sector takeover activity. There are several possible advantages to be gained through merging. These include the removal of excess capacity in the industry—to the extent that this exists—and the generation of economies of scale. As regards the latter, economies could be derived, for example, from a more efficient use of capital or lower average operating or funding costs. The corollary of the increasing need for scale is that it has become more difficult for the smaller societies to survive. Indeed, in this context, an ability to develop niche markets has proved important.

Nevertheless, almost all societies have found it possible to come to terms with recent changes in their markets without changing their essential identity. Only one—Abbey National—has so far found the provisions of the 1986 Act too restrictive and converted to a plc. While further conversions remain possible, widespread moves seem unlikely in the near future.⁽⁶⁾ Equally, so far no outside institution has taken over a building society although, again, this remains a possibility. In contrast, however, most of the large societies have fostered links with other institutions. In particular, they have purchased or formed strategic alliances with insurance companies (to gain commission on the sale of endowment policies) and estate agents (to enhance their distribution capabilities). On the retail deposits side, it is noteworthy that Alliance and Leicester has recently acquired Girobank.

Building society behaviour in 1990

Building societies' behaviour in 1990 outlines many of the behavioural features described above. Bank base rates remained at 15% for a year from October 1989. Through most of last year and the early part of 1990 societies held

mortgage rates below base rates (and money-market rates) as they strove both to limit the effects of higher interest rates on mortgagors and also to increase market share. As a consequence, however, the rates paid on society retail deposits were held relatively low and, as a result, in the latter part of 1989 and early 1990, retail inflows were subdued. Once the Abbey National raised its mortgage and deposit rates in February this year building societies had little option but to follow if they were to remain competitive in the retail deposit market. The increase in rates has restored the positive differential between base mortgage rates and money-market rates. This has been maintained with regard to the mortgage rate cuts announced following the reduction in the base rate to 14%.

Higher deposit rates encouraged an improvement in retail inflows. Societies further enhanced these through additional moves. In particular, prior to the Budget it was feared that the introduction of independent taxation for husbands and wives as from 6 April could lead to a substantial outflow from society accounts to certain national savings instruments and offshore funds. However, the proposed abolition of composite rate tax in April 1991 and the establishment of offshore and deferred interest accounts by the societies had an offsetting effect. So far this year, societies have continually adjusted their wholesale inflows; the effect has been that their aggregate liquidity ratio has remained at approximately 15.3%. In the first quarter, wholesale inflows were substantial—£3.4 billion—in order to counterbalance weak retail flows. As the latter improved, over the following two quarters wholesale inflows fell to an average of £1.8 billion.

Building societies' lending has eased in 1990, running at a quarterly rate of £6.8 billion in the first nine months of the year compared with £7.1 billion in the second half of last year. Nevertheless, it remains strong by historical standards. The average twelve-month growth rate in the year so far is 19.4%. One factor underlying the continued strength of lending could be a stabilisation of conditions in the housing market. It is, however, also consistent with a high rate of

equity extraction. A further factor underpinning lending has been the range of discounted deals offered by building societies. Once these are taken into account, the societies have a clear competitive advantage over the banks. In addition, the former offer a wider and usually more attractive range of options on fixed-rate loans. Thus, as in 1989, societies' share of the mortgage market remains high by historical standards.

Conclusion

Over the past decade building societies have changed in a number of important ways. Legislative, structural and regulatory developments have been the most important factors behind these changes. Whereas in the 1970s, building societies, protected by the cartel, were subject to little competition, the deregulation of the banking sector at the beginning of the 1980s led to more direct competition between building societies and banks. Legislative restrictions put societies at a disadvantage at this time and they were unable to respond fully to the new competitive environment. They were also hindered by their initial unwillingness to abandon the cartel. The Building Societies Act of 1986 gave societies more scope to compete effectively.

As a result of these developments, the savings and mortgage markets have experienced significant change. The prices of both mortgage and savings products have become increasingly market related. In particular, mortgages now tend to be rationed by price rather than quantity. Correspondingly, substantial product differentiation has occurred and consumers can now choose from a wide range of products. The strains of increased competition have strongly influenced the structure and behaviour of the industry, leading to a blurring of the roles of the banks and the larger societies, and an increase in mergers. These trends should not, however, be exaggerated since, for the most part, societies remain separate financial entities with a distinctive nature.