

INSTITUTE OF BANKERS, CAMBRIDGE SEMINAR, 6-11 SEPTEMBER 1987

HOW OTHERS SEE US

Text of Speech by Mark Boleat, Director-General, The Building Societies
Association

Introduction

The largest British clearing banks are all international financial conglomerates, and most other British banks also operate in a number of financial markets, some of which have comparatively little in common with others. For example, the only common linkage between the British retail savings market and the financing of international trade is money itself, and the characteristics needed for the two types of business are very different.

British building societies, by contrast, operate in fairly narrowly defined retail financial markets in Britain. In these markets their main competitors are the clearing banks and the competition between the two sets of institutions is an interesting case study of the relative positions of general financial institutions and those confined to more specific services.

This paper concentrates predominantly on British building societies, illustrating how they have been successful over the years, discussing the reasons for this success and considering in detail the present market position of banks as against building societies in particular, and other financial institutions generally. Finally, it speculates on future developments.

The Success of Building Societies

A brief examination of the statistics is adequate to show how successful British building societies have been in the post-war period.

In the markets in which they have operated they have inexorably increased market share, they have established an excellent reputation with the public, and, as institutions, they have grown both steadily and profitably without the traumas that many other financial institutions have suffered. In the savings market it is estimated that building societies accounted for only 10% of personal sector liquid deposits in 1950, with the banks and national savings holding the other 90% almost equally. Building societies have steadily increased their market share such that they now hold about 50% of the liquid assets of the personal sector. This increase in market share was initially at the expense of national savings but more recently has also been at the expense of the banks.

This performance is perhaps put in better perspective when it is realised that building societies do not, for the most part, compete for transaction accounts, banks still having a near monopoly here. If the market for liquid savings is considered then societies probably have a market share of around two-thirds. This dominance of the retail savings market by a group of specialized housing finance institutions is unique in the industrialized world.

Societies' record in the mortgage market has been every bit as spectacular. Detailed figures are not available for the share of the mortgage market in the same way as they are for the share of the savings market. However, an examination of building society lending on new housing, compared with the number of new houses completed, shows that societies steadily increased their share of total mortgage business from perhaps 60% in the 1950s to 80% by the early 1980s. The latest figures show that societies have some three quarters of outstanding mortgage loans.

Societies have been extremely successful in two markets which themselves have been growing rapidly, and therefore societies themselves have increased rapidly in size, employing more and more people and earning an ever greater volume of profits. They have emerged from being fairly insignificant peripheral institutions immediately after the war to major players in the British financial markets today.

In addition to this, societies have managed to stay popular institutions enjoying a far better public image than the banks. Societies are perceived as being more friendly institutions with which to deal and they do not have the remoteness that many people feel about their banks. This has been illustrated by a number of market research surveys.

Reasons for the Success of Building Societies

There are a number of reasons why building societies have been very successful institutions, particularly in relation to the banks. Those in the building society industry would naturally like to feel that their success is because they have been incredibly efficient and that the banks have not been able to match them. While there may be some truth in this, there are more fundamental factors and, simply put, it can be said that building societies have enjoyed exceptionally favourable market conditions which they have exploited with supreme efficiency.

Societies have been fortunate in that the law has, until recently, confined them to operating in two markets but those two markets have been, for various reasons, rapidly growing. Societies' ultimate product

is, of course, the mortgage loan and few markets in Britain have been more favoured than the mortgage market. It has been favoured not just by one factor but by a combination.

First, most people take out mortgage loans in order to purchase houses and the house purchase market has been particularly favoured. In Britain there is no market rented sector of housing and accordingly there is an artificial demand for owner-occupation. The proportion of homes which are owner-occupied has increased from 29% in 1950 to well over 60% now and seems likely to increase to about 75% by the turn of the century. In Britain people become owner-occupiers at a very early age and no other industrialized country can show the same proportion of owner-occupation among 25 year olds as Britain. Of all countries in the industrialised world, Britain has also shown the most rapid growth in owner-occupation.

The growth in demand for home ownership was accentuated during the 1970s in particular by the favourable tax treatment of owner-occupied homes. For a time during that decade the only investment that people could make which was certain to keep pace with inflation, and which was not subject to Capital Gains Tax, was their own home. Housing therefore became an investment good as well as a consumption good.

This artificial demand for home-ownership has naturally stimulated an artificial demand for mortgage loans, the main product of building societies. However, mortgage loans themselves have also been favourably treated for tax purposes. Mortgage interest is tax deductible and until 1974 that tax deductibility was unlimited. Until the last few years, most people could, effectively, obtain full tax relief on the loan which they took out to purchase their home.

Mortgage lending has also been exceptionally safe for financial institutions, partly because the lack of a market rented sector has virtually removed the risk of a large scale collapse of the owner-occupied housing market in Britain such as that which has occurred, for example, in Belgium and the Netherlands. The availability of supplementary benefit to meet mortgage interest payments of unemployed home owners has similarly helped to underpin the housing finance market. The combination of these factors has meant that mortgage losses have been minimal and therefore interest rates have been kept at a low level thus further stimulating demand.

Indeed, the favourable tax treatment of mortgage loans together with the safe nature of mortgage lending has meant that most people have been able to borrow on mortgage at a lower interest rate than they have been able to obtain on their savings. This has been particularly true for higher rate tax payers who have been able to enjoy a combination of tax free investment in Government instruments and tax relieved debt.

The mortgage market has therefore boomed, growing by some 18% a year, yet it has remained an exceptionally safe market losses being miniscule compared with those recorded on other forms of lending.

Given such a favourable market situation, one would therefore expect large numbers of lenders seeking to compete in this market. Here, building societies enjoyed their greatest advantage. The fact is that for much of the 1960s and 1970s their natural competitors were prevented from competing. In most housing finance markets in the world one finds a variety of lenders including commercial banks, cooperative banks,

savings banks, specialist mortgage banks, and sometimes building society type institutions. In Britain there has been no cooperative bank sector, presumably because industrialisation in Britain occurred earlier than in most other countries. The savings banks hardly existed in terms of lending until recently and generally the fact that they were under Government control prevented them from competing effectively with building societies. The commercial banks were subject to a variety of constraints operated as part of monetary policy throughout the 1960s and 1970s, all of which discouraged them from seeking to increase their deposits or expand their lending. The banks reacted, not surprisingly, by withdrawing to some extent from the personal market, this being exemplified by their decisions to close on Saturday mornings and also by their paying derisory rates of interest on savings accounts.

The reasons for the success of building societies are therefore apparent. Societies operated by law in two tightly confined markets yet for a variety of unrelated factors these markets were rapidly growing, and societies' natural competitors in these markets were prevented from competing with them. This idyllic state of affairs led to the rapid growth of the building society industry and by the early 1980s it had taken its place as one of the key financial sectors in the British economy.

The Changing Competitive Environment

The situation has changed dramatically over the past few years. Building societies are now being challenged in markets which they made their own and in turn building societies have moved into other markets. The reasons for the breaking down of the barriers between financial

markets and institutions have been well described elsewhere and will be only briefly summarised here. Technology has made barriers between markets difficult to sustain and has also made non-market policy instruments ineffective. The corset was rendered ineffective by banks simply guaranteeing loans made from one of their customers to another rather than making the loans and accepting deposits themselves. More sophisticated computer systems enabled such constraints to be overcome more effectively.

Governments also realised that artificial constraints inhibited the efficient functioning of financial institutions. Banks had responded quite sensibly, from their point of view, to the constraints imposed on them by reducing the level of customer service. What was the point of opening on Saturday mornings and offering good interest rates to depositors if the main effect of this was to be penalised by the Government? The break-up of the bank cartel in the 1970s was perceived to have increased the efficiency of the banking industry and the newly elected Conservative Government in 1979 was anxious to build on this experience.

The abolition of exchange controls in 1979 led inevitably to the abolition of the corset in 1980 and for the first time the banks were free to compete with building societies for savings and mortgage loans without being subject to any artificial balance sheet constraints. The steady decline in the banks' share of personal business was beginning to cause problems. The banks had become increasingly reliant on wholesale rather than retail deposits and, more generally, there is no point in having some 12,000 branches if one is not predominantly in the retail market. The banks were therefore anxious to regain their place in the

personal market and perceived that this could be done relatively easily because they already had the customers, the staff and the branches and all that they needed were the products. Accordingly, the banks attacked the mortgage market vigorously and also offered more attractive savings accounts. Inevitably, as with any new entrant into the market, the banks did not make a complete success of it and indeed their early experience in the mortgage market was somewhat messy with surges of lending being followed by equally rapid withdrawals from the market. However, it is clear that banks are now in the mortgage market to stay and they have produced many of the innovations in the market and moreover have forced building societies to reconsider their pricing policies.

The banks are not the only new entrants in the mortgage market. The advent of a more competitive mortgage market has encouraged a number of institutional investors to set up specialist mortgage lending companies, funded on the wholesale markets and which obtain mortgage business through intermediaries.

There is, therefore, a very competitive mortgage market with building societies but one of a number of types of supplier. There is virtually no brand loyalty towards particular mortgage lenders and indeed a mortgage loan is a product that is difficult to differentiate. One mortgage is much the same as another in the same way as one potato is much the same as another.

As building societies have experienced strong competition in their traditional markets, so they have been able to move into new markets themselves. Any institution coming under threat in one market has

to look at whether it has comparative advantage in other markets. Building societies built on their strengths, their strong customer base, popular public image, large scale branch networks, and dominance of the retail savings and mortgage markets. New technology meant that it became easier for societies to offer limited money transmission facilities, often in conjunction with smaller banks or other financial institutions. Societies were able to use the latest technology to install more efficient automated teller machines than the banks. In the mortgage market, societies exploited the opportunities to capture related business such as insurance broking and arranging unsecured loans.

There has been a rebundling of services in the savings and mortgage markets. A competitive mortgage market has shifted the balance of power away from the providers of mortgage funds towards the providers of mortgage applicants and the estate agency business is accordingly undergoing a rapid change with agents themselves moving into the financial services market and financial institutions building up networks of estate agencies both to secure their source of mortgage business and again, related business, for example, insurance. The savings market and the market for money transmission services are becoming merged with the customer now expecting an account which offers both a high rate of interest and money transmission services.

In this new market place building societies are less well placed than they were to provide mortgages, but very well placed to provide other financial services.

However, societies were constrained from competing fully by a legal framework which dated back to 1874 and which, broadly speaking,

prevented them from doing anything other than making mortgage loans and attracting retail deposits and services directly incidental to those main functions. This problem for societies was rectified by the passage through Parliament of legislation which became the Building Societies Act 1986 and which freed societies to make unsecured loans and to provide the full range of house-buying and financial services.

By early 1987 banks and building societies had both been freed of the constraints which prevented them from competing across the full range of retail business and market conditions had changed dramatically over the few previous years. It is against this backdrop that one can examine the present market position of banks as against building societies in particular.

The Present Market Position of Banks as Against Other Institutions

Building societies certainly see banks as being their major competitors although they are certainly not their only competitors. In the mortgage market the running is sometimes being made by the new mortgage companies which have found a perfect niche in the market and which are sensibly operating by obtaining their funds at the lowest cost, taking the most profitable mortgage business, and keeping their operating costs to a minimum.

In competing with building societies banks have three main advantages. The first is their huge customer base. They have more customers than building societies, this in turn reflecting their total domination of the money transmission business. Only in the past few years have societies begun to offer current accounts and, even so, most people who

have such accounts with building societies, also have them with banks. Armed with the huge number of people with bank accounts and with still a very large share of the personal sector money transmission business, banks have the essential ingredient to offer a wide range of financial services, that is, the customer base and control of the key financial product, the current account.

The banks also have comprehensive branch networks, the largest in the world for large commercial banks. They have large offices in all of the large cities and towns and their branch networks stem to suburban areas and small towns although obviously the same services cannot be offered through small branches as through larger ones.

The banks have begun to use these advantages by cross-selling products. Direct mail is rapidly becoming a major method of marketing financial services. It is cheap and is most likely to attract sophisticated customers who can often be most profitable. By contrast, selling a product through branches is very expensive and people who actually have the time to visit branches to discuss financial products may well be those who are not likely to be very profitable to a financial institution.

Notwithstanding those great advantages, the banks also have a number of disadvantages. The first of those is that although they have a large customer base, one suspects that they do not have the computer systems to enable them readily to use customer information for marketing purposes. This is clearly illustrated by the fact that banks seem to spend much time selling services, which people already have, through direct mail. The TSB and, to take a non-bank example, American Express,

must spend vast amounts of money marketing Visa cards and American Express cards to people who already have them, so clearly they do not have a marketing system which enables them to cut out existing customers. But it is not sufficient just to know who is one's customer. Rather, one needs to know a fair bit about the customer in terms of income, other financial products purchased and so on. One understands that banks, like building societies, are endeavouring to deal with this situation by completely reorganising the format in which information is held, basically switching it from account based information to customer based information. Until the banks successfully do this, they are not able to make effective use of their customer base.

A second constraint on the banks' advantages is that because they have been first in the market for a number of services, in particular, automated teller machines, they now have the oldest technology, whereas new institutions in the market, like building societies, can take advantage of the latest technology. Building societies can now provide money transmission services every bit as good and probably better than most of those offered by banks. They are able to do so either on their own account or by using banks to clear cheques and here one should note that the status of a clearing bank is of not the slightest interest to the retail customer. It may be of interest in the banking world as to whether a building society is a member of the clearing system but all the customer is concerned about is whether he has a cheque which will be accepted. The fact that it has to go through two stages before being cleared rather than one is probably an advantage rather than a disadvantage if it takes longer to clear cheques.

A final disadvantage that the banks have, one shared by building societies, although not to the same extent, is that branches are an

increasingly inefficient method of delivering retail financial services. Broadly speaking, it can be said that it must be inefficient to use a physical location to sell a non-physical product such as a loan, a savings account or money transmission services. Branches were certainly essential when there were no ATMs because they were a method of paying in cash to a bank and getting cash out. Now, however, people can service all of their cash requirements through ATMs. Of course, it is true that some people prefer to use a branch but providing cash services through a branch is very much more expensive than providing them through an ATM in that staff have to be employed who for some of their time will not be fully utilized and may spend a considerable amount of time dealing with customers which clearly cannot be profitable for the bank.

Some people, of course, want to discuss products that they are buying and these customers can be particularly inefficient for the institution. Any bank manager should be charging out his time at at least £50 an hour and a half-hour chat with an elderly customer would have to generate a huge amount of business in order to pay for the time of the bank manager.

There is a grave danger that bank branches will go much the same way as some high street shopping centres, and indeed trends in the two are related. Increasingly, out of town shopping centres are becoming more important and large supermarkets with car parking facilities are pushing traditional high streets out of business. Of course, the high streets are still necessary for people who live locally and do not have cars. However, a characteristic shared by people who do not have cars is that they do not have much money either and one therefore finds some high

streets increasingly being pushed down market in terms of the shops that are there and the people that are using them, and the downward spiral feeds on itself. Meanwhile, the more affluent customers are travelling fairly short distances by car to do all their shopping in a convenient manner which suits them.

Most sophisticated customers who can be profitable bank or building society customers never set foot in their branches and the people who do use branches, in many cases, are not profitable, for example, a small trader bringing in masses of coins which he wants paid into his account or taking out masses of change, and the person who has got nothing better to do than to spend half an hour talking to branch staff about investing a few hundred pounds in one product or another.

Both banks and building societies have probably got more branches than they need to sell the services which they are now offering, but for banks the problem is greater because they have got much more investment tied up in these branches than building societies.

Building societies therefore see banks as their main competitors because they have got the customers, the branches, and the expertise. But, each of these advantages are now slightly tempered and building societies can compete effectively against banks in all of the retail markets.

Societies do not have as many branches but then clearly they no longer need them. They don't have the same expertise but that expertise can be relatively easily acquired by linking with other financial institutions to provide, for example, cheque book accounts, and by use of the latest technology which enables societies to provide comprehensive insurance broking services through their branches without employing any expert staff in those branches at all.

Societies feel that when they are selling products through branches, then they do have the great advantage of a much better public image and this spills over into any products which they sell. Building societies are fortunate because they sell popular products whereas banks sell unpopular products. While there is every justification for making bank charges the sad fact is that the public do not understand this although it has to be said that this is partly because the banks, or at least some of them, have done their best to ensure that the public do not understand it by continually referring to free banking.

The balance of competitive advantage between banks and building societies is a very fine one. The banks have found the mortgage market to be a profitable one and are also now much more of a threat in the retail savings market. They have the customer base, the branch network, the staff and the expertise to be major players in the retail financial services market. However, they have more restructuring to do in order to take advantage of this market place. That restructuring has to include branch closures and much more radical changes in the method of operation. Building societies, by contrast, are still on the way up. They have just been empowered to offer many new services and they are in a position of expanding rather than contracting. As new entrants they start with significant advantages, including their huge customer base which they are better able to utilise for marketing purposes than the banks, and they are not so encumbered by employing people and facilities which are no longer inappropriate to the market place.

The Future

How will the banks fare in this brave new world against their competitors? In the retail financial markets, they will certainly find building societies to be their strongest although not their only competitors. Modern technology and the removal of regulatory constraints mean that it is open to almost any institution to provide retail financial services including current accounts, mortgages, savings accounts, life insurance products and so on. The retailers are particularly well placed here and there is also room for niche institutions concentrating on particular highly specialised lines of business and obtaining their business through links with other organisations.

The banks can be expected to gain market share in those areas where they are currently not very strong. One would expect them to be able easily to maintain a 20% share of the mortgage business and moreover for this to be very profitable for them. At a push they could possibly increasing their market share up to 30% although this might entail some securitisation of mortgage loans given the heavy capital backing which the banks are required to maintain for their mortgage lending business, a far higher capital backing than building societies are required to maintain.

When they obtain mortgage business, banks can be expected to sell ancillary products such as unsecured loans and life and buildings insurance. These are all areas where the banks can be expected to gain business over the next few years.

Conversely, banks can be expected to lose business in areas where building societies now enjoy a strong comparative advantage. In the same way that banks were artificially prevented from competing with building societies in the savings and mortgage markets in the 1960s and 1970s, so building societies were artificially prevented from competing with banks in the markets for money transmission services, unsecured loans and credit cards. In advanced, industrialised countries, building societies are almost alone as being significant savings institutions without the full range of retail financial services. Until their new Act, societies were prevented from offering credit cards, unsecured loans and reasonable money transmission facilities. Now, societies have been freed to offer all of these products.

Unsecured loans is one area where building societies can be expected to do very well. In the past, societies found themselves in the absurd position of giving people mortgage loans to buy their houses but when those people asked whether they could borrow a little extra to purchase furniture and fittings the societies directed them across the road to the bank where they were charged a much higher rate of interest than building societies would have found it necessary to charge. Building societies can now be expected to capture this business.

Similarly, building societies can be expected to become major players in the credit card market. They can use their strong customer base, which they are much better equipped to exploit than are the banks, to provide Visa or Access cards or indeed some other form of credit card; already societies are beginning to make moves in this direction.

Perhaps the banks have most to fear in respect of their core retail business, the cheque book account. The banks have not had to work very

hard to get current account business in the past because they have enjoyed a monopoly. It has been almost impossible for many people to be paid or for student grants to be used unless one has a bank account. Now, building societies are able to offer similar accounts and indeed because they can design these products de novo they can often make them both more attractive to the customer and more profitable for themselves. For building societies it is not a question of imposing charges on those who previously have not been charged because societies have previously not had current account customers. They can gear their pricing structure to what they consider appropriate and capture the type of business they want rather than be lumbered with the type of business that nobody actually wants.

Societies have been remarkably successful in the market for childrens' savings, now having some 40% of all children as their investors. Societies are not doing this out of any charitable motive of teaching children about money management, although this does come into it. Rather, when those children reach the age when they want full banking services, building societies will already have them as customers and will seek to capture them as banking customers before the banks get a look in. The banks are well aware of this and it is for this reason that they too have entered the childrens' market.

Building societies have a natural place in the market for money transmission services in the same way as banks have a natural place in the mortgage market. Building societies can be expected to compete aggressively for retail banking business and will take a significant proportion of it away from banks, while they in turn lose share of the mortgage market to the banks.

This is the market situation that one would have expected. Comparative advantage has changed because of technological developments and deregulation, and each institution now has to work out the markets in which it is best placed and how it can best exploit those markets. This might mean turning one's back on markets that have been successful in the past because new market conditions might not allow the same institutions to be as successful in those markets as previously.

The building societies gained when the banks were heavily regulated in the 1960s and 1970s. In the early 1980s the banks were deregulated but the building societies were shackled by an outmoded legal framework. Now the building societies have also been freed from their constraints and for the first time banks and building societies are completely free to compete across the whole range of retail financial services, relatively unencumbered by regulatory distortions. There is no particular reason to expect banks or building societies to come out on top as a group. Rather, one would expect the most efficient banks and building societies to do best and the least efficient institutions to do very badly indeed.

Were it not for the special legal status of building societies, one would expect a merger between banks and building societies. However, given the constitution of building societies under the 1986 Act this would be very difficult to effect. A building society can convert to a public company but it could do so, and lose its own independence, only by persuading 50% of its investing shareholders to vote in favour. This would be extremely difficult although perhaps not impossible. However, one would not rule out one or two perhaps medium-sized building societies going for the conversion option, perhaps linking with other financial institutions which wish to expand their retail financial business.

The banks will continue to be the dominant institutions in the British financial markets. However, in the retail markets, with the exception of money transmission services, they lost that dominance a long time ago. I doubt that they will regain it. The retail financial markets will form a significant but not huge part of their business. They will have to face very strong competition from building societies which will be specialist in this market and are perceived as being so. Banks will have to work very hard in order to maintain, let alone improve, their performance in the retail financial markets. Building societies have no other markets to turn to given their present legal position whereas banks, if they do not like the British retail market, have other avenues in which they can use their funds and their staff. Perhaps this factor might prove to be the crucial one in the long term.