Building Societies and Housing Finance in Britain

by Mark Boleat

Editor's Note: *This is the second in a series of articles about America's building and savings and loan counterparts in other countries. The author is deputy secretary-general of The Building Societies Association of Britain, headquartered in the Mayfair district of London. The views expressed in this article are those of the author and do not necessarily reflect the views of the Federal Home Loan Bank Board.*

The development of building societies and, more generally, of housing finance in Britain is relevant to students of the savings and loan industry in the United States because of the significant similarities in the two countries. In both countries, owner-occupation is the most common form of tenure and unlike, for example, on the Continent of Europe, loans for house purchase are provided predominantly by specialist institutions, the building societies in Britain, and the more aptly named savings and loan associations in the United States. (Contrary to their name, building societies do not actually build nor are they societies. Unlike their counterparts in the United States and other countries, they simply have not changed their names from their origins of more than 200 years ago when they were truly "building societies.")

However, there are also differences between the two countries, differences which can help each country learn from the other. The most significant difference is that the savings and loan industry in the United States is far more regulated than the building societies in Britain. (At least, that was the case prior to the passage of the Garn-St Germain legislation by the US Congress in October 1982.) For example, in Britain, there have been and are no regulations on interest rates that can be paid or charged and no limitations on the geographical operations of individual financial institutions, the latter having been changed in America recently for emergency situations by former Federal Home Loan Bank Board Chairman Richard T. Pratt.

This article briefly sets out the present state of housing finance and building societies in Britain and, where possible, makes comparisons with the United States.

Housing Finance in Britain

In order to understand how the housing finance market operates in Britain, it is first necessary to understand a little about housing. Owner-occupation is now the most common form of tenure, accounting for 57.5 percent of all dwellings. However, owner-occupation is a relatively new phenomenon in Britain, unlike the United States where the majority of homes has been owned since the beginning of the Century. The proportion of owner-occupied dwellings was a little more than ten percent in 1914 and, as recently as 1950, it was only 30 percent. The growth of owner-occupation has largely been accounted for by the transfer of dwellings from the private rented sector where restrictive legislation has made it increasingly uneconomical for landlords to rent out property. Nearly one-third of homes in Britain are rented from local councils (governments), a very different position from that in the United States. The present government is energetically implementing a policy of selling council houses to tenants and this has helped contribute to the growth of owner-occupation in the last two or three years, in particular.

In practice, most newly formed households have little choice but to seek to become owner-occupiers. There is virtually no private rented housing left and council housing is not generally available to single people or to childless couples. Even when it is available, the bureaucratic manner in which it is allocated is no longer acceptable to most households who wish to exercise some degree of choice as to their home. Eighty percent of young people have expressed a wish for owner-occupation and as many as 60 percent of all households are owner-occupiers by the time they are age 30. The housing finance system has had to adapt to be able to help young people, inevitably people with comparatively modest incomes and savings, to be able to buy their homes.

Until fairly recently, building societies held a virtual monopoly of the supply of mortgage finance. They accounted for some 80 percent of outstanding mortgage debt and their share of new loans rose as high as 95 percent in the late 1970s. It is helpful to examine why the state of affairs, virtually unique in advanced coun-

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Table 1.—Loans for House Purchase, 1981–82

Institution	1981				1982			
	Net Advances		Balances Outstanding		Net Advances		Balances Outstanding	
	£m	Percent	£m	Percent	£m	Percent	£m	Percent
Building societies	6,331	64.5	49,039	79.1	7,885	58.1	56,894	75.4
Local authorities	252	2.6	3,906	6.3	535	3.9	4,441	5.9
Insurance companies and pension funds	239	2.4	2,204	3.6	170	1.3	2,374	3.1
Monetary sector	2,240	22.8	5,340	8.6	4,660	34.3	10,297	13.6
Savings banks	182	1.9	297	0.5				
Others	348	3.5	1,169	1.9	320	2.4	1,489	2.0
Total	9,822	100.0	61,958	100.0	13,570	100.0	75,495	100.0

Sources: *Financial Statistics* and Building Societies Association estimates.

tries, existed. The banks and savings banks are the natural mortgage lenders in most countries, together with specialist institutions such as building societies. In Britain, the savings banks are very small compared with building societies, largely because they have been under government control and have not been allowed to operate with competitive interest rates. Until two or three years ago, they did little more than hand over all the savings they collected to the government and they did not offer loans at all. The commercial banks were, throughout the 1960s and 1970s, subject to an array of direct controls on their lending and deposit-taking activities, all of which had the effect of limiting their ability to take on new business. Moreover, the banks traditionally have been more oriented towards the corporate customer rather than the individual and, to a large extent, they were content to leave the field of mortgage loans and, indeed, also the savings market, to the building societies. Thus, largely through default, building societies became not only the significant providers of loans to the rapidly growing owner-occupation market, but they also came to dominate the personal savings market, accounting for nearly 50 percent of the liquid assets of the personal sector and perhaps as much as 70 percent of what might be described as the genuine short-term savings of individuals.

Over the last two or three years, there has been a marked change in the situation with building societies having to face significantly greater competition. The savings banks are gradually moving from the public sector into the private sector and have been allowed to make mortgage loans and have rapidly developed this form of lending, although it remains very small in relation to that undertaken by building societies. More importantly, the banks were, in 1980, freed from most of the direct controls under which they operated, the government realizing that operating monetary policy through acting on the banks alone was not only unsuccessful, but it also unfairly inhibited the banks in competing with building societies. The banks responded to their new-found freedom by aggressively entering the home-loans market and also extending the range of their savings products. By the end of 1981, they accounted for no less than 40 percent of new mortgage business although, more recently, they have been cutting back on their lending and seem likely to be content with perhaps 20 percent of the market. Table 1 shows trends in lending for house purchase over the last few years.

Broadly speaking, there are no regulations governing house purchase loans. Lenders are free to lend as much as they like in relation to the value of the house and in relation to the income of the borrower. There are no laws restricting the rates of interest which may be charged and, for many years, all loans have been made on the variable rate basis. Modern mortgage contracts permit lenders to vary the rate of interest on existing loans with as little as seven days' notice and there is no limitation on how much or how frequently rates can be changed. Thus, between June 1978 and December 1979, most borrowers experienced an increase in their mortgage rates from 8.5 percent to 15 percent. More recently, during the course of 1982, most mortgage rates declined from 15 percent at the beginning of the year to 10 percent at the end. Although changes in the mortgage rates are items of significant public interest, affecting, as they do, about a quarter of all households, they are readily accepted by the British public and have not caused the problems that many seemed to fear when variable mortgage rates were introduced in the United States.

It is significant to note that, until March 1983, interest on mortgage loans of up to £25,000 (approximately US$39,400), a little below the average house price, qualified for tax relief at the borrower's highest marginal rate. This limit had been in force since 1974 and since then house prices have increased by some 250

Table 2.—Classification of Building Societies by Asset Size, End 1981

Assets	Number of Societies	Percentage of Total	Total Assets £m	Percentage of Total
Over £3,000 million	5	2.0	34,077	55.1
Over £700 million up to £3,000 million	12	4.8	17,056	27.6
Over £160 million up to £700 million	21	8.4	5,575	9.0
Over £40 million up to £160 million	46	18.3	3,721	6.0
Over £2 million up to £40 million	105	41.8	1,351	2.2
Up to £2 million	62	24.7	27	—
Total	251	100.0	61,809	100.0

Source: *Building Societies in 1981*, The Building Societies Association, London, 1982.

percent. In March 1983, the government granted a modest increase in the limit—to £30,000—but it will still affect a significant number of first-time buyers.

Building Societies

It is apparent that building societies are central to the housing-finance system of Britain and it is relevant to examine in detail their method of operation and to contrast it with that of the American savings and loan associations.

The first societies were established in the late Eighteenth Century. They were true "building societies" in that they comprised of small groups of people who pooled their resources to build themselves homes. During the Nineteenth Century, societies moved rapidly from being self-help building organizations to financial institutions lending for house-purchase. Building societies were given legal recognition in 1836 and, in 1874, the first comprehensive legislation governing their activities was enacted. Much of this legislation is still intact today.

Building societies are subject to special legislation and not the normal law affecting corporations. Current legislation is the Building Societies Act 1962, together with various statutory instruments made under that and other Acts of Parliament. Section 1 of the Act states that the purpose for which a building society may be established "is of raising, by the subscriptions of the members, a stock or fund for making advances to members out of the funds of the society upon security by way of mortgage of freehold or leasehold estate." The Act is restrictive and societies are able to do only those things specifically prescribed by legislation. Building societies are all mutual, that is, they are owned by their investing and borrowing members. This mutual status presents some complications in that most building society customers want only to be depositors or borrowers and have no wish to take part in the management of their societies.

The Act lays down strict rules on how societies can raise and use their funds and it limits the kind of business which they can do. Societies cannot indulge in activities other than raising funds or making house-purchase loans unless these are closely related to those lines of business. Moreover, their form of ownership means they can neither have subsidiaries nor can they be owned by other organizations. There is a sharp contrast here with the position in the United States, where savings and loan associations can be subsidiaries of other commercial organizations and can engage in activities such as house building, real estate brokerage, and consumer lending through service corporations.

Building societies are subject to very few and modest prudential regulations and they have to face no more than two or three new regulations a year. The most important of these is a requirement that liquid funds should be not less than 7.5 percent of total assets and reserves (net worth in American terms) should exceed a certain minimum depending on the size of the society. The minimum varies from 2.5 percent of assets for the smallest societies going down to 1.25 percent of any assets exceeding £1,000 million.

Building societies, like savings and loan associations, have their own regulatory body. This body is called, somewhat quaintly, the Registry of Friendly Societies and the relevant official is the Chief Registrar of Friendly Societies. The Registry is a very small organization compared with the Federal Home Loan Bank Board, employing some 120 staff and only a quarter of its work concerns building societies.

The number of building societies has fallen quite significantly during the Twentieth Century, largely as a result of small societies going out of business and mergers to create larger units. At the end of 1982, there were 227 building societies, a sharp reduction compared with a figure of 456 as recently as 1972.

Because building societies are able to operate throughout the entire country, the industry is much more concentrated than is the savings and loan industry

Table 3.—Building Societies' Assets and Liabilities, End-1981 and End-1982

Liabilities	1981 £m	1981 Percent	1982 £m	1982 Percent
Shares	55,456	89.7	66,468	90.0
Deposits	2,540	4.1	2,953	4.0
Loans	38	0.1	150	0.2
Taxation and other	1,496	2.4	1,510	2.0
General reserves	2,279	3.7	2,765	3.7
Total	61,809	100.0	73,846	100.0

Assets	1981 £m	1981 Percent	1982 £m	1982 Percent
Mortgages	48,854	79.0	56,894	77.0
Cash and investments	12,069	19.5	15,197	20.6
Office premises	726	1.2		
Other assets	160	0.3		
Total	61,809	100.0	73,846	100.0

Source: The Building Societies Association.

in the United States. Table 2 shows the distribution of societies by size at the end of 1981.

It will be seen that the five largest societies accounted for no less than 55 percent of the total assets of the industry. This is in sharp contrast with the United States where the largest 100 associations account for only about a third of the total assets of the industry. The largest society, the Halifax, can claim to be the biggest in the world, although mergers between Californian savings and loan associations and movements in the sterling/dollar exchange rate are capable of affecting this position! The twelve societies immediately below the largest five accounted for a further 28 percent of total assets at the end of 1981. These societies operate throughout most of, if not all, the country, and have to compete against both the large national societies and strong regional societies. Two significant mergers within this group of societies have recently been announced. The very small societies, those with assets under £2 million, are so small as to be insignificant for most purposes, but there is a large number of societies operating from just one office, or perhaps one head office and a few neighboring offices, which still form a significant part of the building society industry.

Like savings and loan associations, building societies operate through networks of branches and there are no limitations on the number of branches they may have or where these branches are located. However, a building society branch counts as an office in terms of planning permission (zoning, in the American sense), and it is not always easy for societies to obtain the necessary permission to establish in town centres. There has been a very rapid growth in the number of branches in recent years—from 3,719 in 1976 to over 6,500 in 1982. However, the rapid expansion of branches has now ended.

Societies also operate through agents, typically professional firms such as solicitors (attorneys), accountants, and estate agents (realtors).

Because building societies are confined to operating in two markets, their balance sheet is extremely simple. Table 3 shows the assets and liabilities of societies at the end of 1981 and 1982. It will be seen that shares accounted for some 90 percent of the liabilities of societies and that deposits accounted for a further four percent. In practice, shares and deposits can be counted together. Until very recently, over 80 percent of shares were in the form of ordinary shares, similar in nature to passbook accounts. A market-related rate of interest was paid on these shares. However, in recent years, societies have offered an increasing range of accounts, including term accounts, which pay a differential over the ordinary share rate in exchange for a fixed investment period, and short notice or penalty accounts whereby a higher than normal rate of interest is payable in exchange either for (1) a period of notice before withdrawal can be made or (2) an interest penalty on immediate withdrawal. There has been a very marked change in the liability structure of building societies over the past two or three years with ordinary shares declining from over 70 percent of the total to little more than 50 percent now. High interest accounts have increased significantly to take nearly 20 percent of the total at the end of 1982. Table 4 shows these trends. This trend is very similar to that in the United States where passbook accounts have declined dramatically in importance at the expense of market-rated accounts. However, the one big difference between the two countries is that all building society interest rates are market related and the difference between the rates on the various accounts is comparatively modest. Thus, at present, most societies are offering a rate of 6.25 percent (net of basic rate of tax) on ordinary or passbook accounts and a rate of 7.25 percent on accounts withdrawable at three months' notice.

Returning to Table 3, one significant, although still fairly small, development in recent years has been that of issuing negotiable bonds, to corporate bodies, which can be traded on the stock market. This practice accounts for the rapid rise in the loans item in Table 3.

Table 4.—Distribution of Building Society Savings Accounts, 1978–82

	Ordinary Accounts		High Interest Accounts		Term Accounts		Regular Savings		Other Accounts		Total
	£m	Percent	£m	Percent	£m	Percent	£m	Percent	£m	Percent	£m
1978	31,430	84.9			3,660	9.9	1,000	2.7	930	2.5	37,020
1979	34,960	81.7			5,560	13.0	1,200	2.8	1,070	2.5	42,790
1980	39,110	78.3	750	1.5	7,340	14.7	1,500	3.0	1,250	2.5	49,950
1981	38,464	67.3	5,609	9.8	9,844	17.2	2,101	3.7	1,130	2.0	57,146
1982	36,498	54.1	11,552	17.1	15,640	23.2	2,284	3.4	1,446	2.1	67,421

Source: The Building Societies Association.

Table 5.—Building Societies' Income and Expenditure, 1980–81

	1980		1981	
	£m	£ per £100 Mean Assets	£m	£ per £100 Mean Assets
Normal Income				
Mortgage interest	5,913	11.88	6,390	11.05
Investment and bank interest	1,072	2.15	1,215	2.10
Commission	98	0.20	127	0.22
Rents	13	0.03	15	0.03
Other (net)	6	0.01	9	0.02
	7,102	14.26	7,757	13.42
Normal Expenditure				
Management expenses	590	1.18	731	1.26
Share, deposit, and loan interest	4,846	9.74	4,982	8.62
Income tax on share and deposit interest	1,372	2.76	1,624	2.81
Corporation tax	113	0.23	153	0.26
	6,922	13.90	7,490	12.96
Normal income less normal expenditure	180	0.36	267	0.46
Investment profits and other exceptional or non-recurrent income (net)	67	0.13	124	0.21
Added to general reserves	247	0.50	391	0.68

Source: *Building Societies in 1981*, The Building Societies Association, London, 1982.

The assets side of the balance sheet of building societies is very simple, with some 80 percent as mortgage loans; 18 percent, cash investments; and 2 percent, other assets. The proportion of assets held in the form of cash and investments is much higher than in the United States. One reason for this is that the rate of interest on mortgages has frequently been below that obtainable on investments. Other important reasons are the total absence of a secondary mortgage market in Britain and also the lack of the ability to finance loans through an institution such as the Federal Home Loan Bank System.

The relatively simple balance sheet of societies is matched by an equally simple income and expenditure account. The figures for 1980 and 1981 are shown in Table 5.

The most important feature of building society operations is that they are all on a variable interest rate basis. If there is a sharp increase in the general level of interest rates, then inflow of funds into societies will subside (disintermediation in American terms), and societies will have to take corrective action to hold their deposits. If there is a sufficiently large increase in the general level of interest rates, building societies will increase their rates so as to hold existing deposits and continue to attract new deposits. The increase in the cost of funds obtained from investors is paid for by an increase in the rate of interest charged to all borrowers, as has been explained earlier. The converse happens when interest rates decline. Thus, building societies are not caught, as have been American savings and loan institutions, by borrowing short and lending long. By moving their rates on their assets and liabilities together, they have always been able to operate profitably and, moreover, the risk of loss has been small. Therefore, the margin between investing and borrowing rates has been able to be kept to a minimum and the societies need hold only very modest reserves. As noted in Table 4, the average reserve ratio (net worth in American terms) of British building societies is well below that thought prudent for S&Ls.

Building societies do not act autonomously in changing their rates. Most follow the recommendations of The Building Societies Association, the trade association for building societies in Britain, equivalent in many ways to the United States League of Savings Institutions. The Council of the Association meets monthly to consider interest rates as well as a wide variety of other matters. Where a change in rates is felt to be necessary, the Council will issue a recommendation to its members. Societies are not obliged to follow these recommendations, but most do so and those which do not generally operate on a fixed margin above The Building Societies Association (BSA) recommendations. This practice might seem to be distinctly uncompetitive, but it has been accepted in Britain because it has acted as a moderating influence, minimizing the extent to which fluctuations in the general level of interest rates feed through to fluctuations in the rates that have to be paid by homebuyers. However, the increasingly competitive nature of the mortgage market over the past few years has meant that mortgage rates are now more determined by the market than used to be the case.

The Future of Building Societies

There have been many significant changes in legislation affecting savings and loan associations over the last few years. British building societies, however, still operate under a 1962 Act of Parliament and, indeed, in many respects this Act is similar to that which was enacted in 1874. The government has indicated that new legislation on building societies can be expected in the next few years. In anticipation of this, The Building Societies Association has recently published its views of what should be included in new legislation (*The Future Constitution and Powers of Building Societies*, The Building Societies Association, London, 1983).

This report suggests that building societies should maintain their status as mutual institutions and it recommends a number of steps which would help make mutuality more effective, given the present size of societies.

More significantly, the report argues that building societies need wider powers for three reasons: (1) to enable them to compete more effectively. Currently, the clearing banks and the savings banks are able to offer a more comprehensive package to investors and borrowers than can building societies; (2) to meet a demand of members of building societies for a wider range of services from their societies and a willingness on the part of societies to provide such services; and (3) to help societies play a wider role in meeting the nation's housing needs. Societies have already become involved in various innovations in the housing market, but they are prevented by their restrictive legislation from playing as wide a role as they should wish.

The report recommends that societies should be permitted to undertake a wider range of functions which are related to their mainstream business in the housing and financial fields and which enable them to make more effective use of their assets. It is stressed that, because societies' mainstream activities are straightforward and well understood, it is essential that new powers should not jeopardize either the image or the financial stability which has served societies and their customers so well. It is recommended that new powers involving little or no financial risk should be operable either in-house by the society or by a subsidiary body corporate. New powers which could involve the use of risk capital should be operated only by a subsidiary.

The concept of the subsidiary is very much new for British building societies and, in putting forward this proposal, the experience of American savings and loan associations was taken into account.

Among the wider powers which societies are seeking are those of acting as realtors, offering structural surveys for intending and existing borrowers, and handling conveyancing work for borrowers. More radically, among the powers which it is suggested could be exercised by a subsidiary are undertaking banking business, establishing an insurance company, and establishing companies able to hold or acquire land. The report also recommends that [British] building societies should be able to operate in the other countries of the European Community.

Conclusion

It will be apparent that building societies in Britain are undergoing much the same pressures as the savings and loan associations in the United States and, indeed, building societies in South Africa and Australia, where the system is very similar to that in Britain. These pressures, basically an increase in competition threatening the viability of specialist housing finance institutions, have been caused by a desire on the part of the government to see greater competition between financial institutions. In America, these pressures have coincided with the inevitable consequences of the restriction of savings and loan associations to lending at fixed rates. United States institutions could have learned a great deal from the operation of the variable rate mortgages in Britain, but there seems to have been a reluctance in the United States to take much note of what has been happening in other countries, and I commend *The Journal* on this series. Britain has, however, been watching carefully developments in other countries and has drawn on their experience, *e.g.*, in putting forward the subsidiary concept in proposals for new legislation. **J**

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