Building Societies: The New Supervisory Framework

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At the beginning of 1987, the Building Societies Act 1986 came into effect, providing for a new supervisory framework and a wider range of powers for Britain's building societies. In February, a new regime for assessing the capital adequacy of societies came into operation, and, later in the year, societies' operations in the financial services market will be regulated under the provisions of the 1986 Financial Services Act. Taken together, these three developments mark a major change in the way that Britain's building societies operate and a significant step in the convergence of the regulation of financial institutions. This article discusses the new supervisory framework for societies.

The traditional position

Traditionally building societies have operated largely on their own financial circuit. They have not been part of the City of London, have not been subject to the same regulations as banks and generally have been treated partly as social services organisations, rather than retail financial institutions. This state of affairs partly reflects the historical development of societies as mutual co-operative organisations.

As recently as 1950, building societies were comparatively small, holding just 10 per cent of retail savings, and although they were significant in the mortgage market, that market itself was small, with owner-occupation accounting for little more than a quarter of all households. Between 1950 and 1980 building societies grew massively, to take over 50 per cent of the retail savings market, and some 75 per cent of a huge and growing mortgage market. (See Table I.) To some extent the success of building societies can be explained by their special nature and the fact that they were outside the main framework of supervision for financial institutions. Because building societies were not banks, they were not treated as banks. For much of the 1960s and 1970s, the banks were subject to balance sheet constraints in the name of monetary policy, but the building societies were not so constrained and were able to take market share away from the banks and also from national savings, which singularly failed to respond to the changing needs of consumers.

Table I
Mortgage loans and personal sector liquid assets in the UK for year end 1986

Institution	Mortgage Loans		Personal Sector Liquid Assets	
	£millions	%	£millions	%
Building societies	116,469	76	115,749	52
Monetary sector	25,774	17	71,723	32
National Savings	—	—	32,874	15
Other	10,235	7	361	—
Total	152,478	100	220,707	100

Source: Financial Statistics, April 1987, Tables 9.4 and 9.5.

By the mid-1970s the massive importance of building societies in the savings and mortgage markets was more readily appreciated, but their mutual nature and special legal powers, deriving from a succession of Acts of Parliament consolidated into the Building Societies Act 1962, meant that they stayed outside the normal framework of supervision for financial institutions. In the mid-1970s, an attempt was made to regulate building societies through the Joint Advisory Committee on Mortgage Finance, which, it was intended, would effectively control the lending activities and interest rates of societies. However, it was unsuccessful in so doing, in the same way that other non-market attempts to control financial institutions have been failures.

Because the success of building societies depended partly on the absence of any competition from their natural competitors, commercial banks and savings banks, societies were always vulnerable to a change in market conditions which removed this artificial advantage which they had enjoyed. Towards the end of the 1970s, such a change duly occurred. The futility of implementing monetary policy through the banking system was increasingly recognised and, following the abolition of exchange controls in 1979, it was only a question of time before the remaining balance sheet controls were removed and this duly occurred with the abolition of the 'corset' in 1980. The banks were, therefore, freed to compete with building societies on equal terms, and they rapidly made in-roads into the mortgage market as well as offering more competitive savings products.

At about the same time, technological progress made it easier for non-traditional institutions to compete in the retail financial markets, by offering, for example, interest bearing current accounts.

The building societies' own success had partially sown the seeds for the inevitable competition which they would face. They had an unnaturally high share of both the mortgage and the savings markets, and this helped to create a mortgage market which was continually under-supplied with funds, partly because of the internal cartel operated by The Building Societies Association itself. The unsatisfied demand for mortgage funds enabled new lenders to come in, catering only for the higher end of the market, and able to obtain business with little difficulty, thereby pushing societies downmarket in their lending.

The need for change

By the early 1980s, it had become clear, both to building societies themselves and to the government, that there was no long term future for institutions which were confined by law to collecting retail savings and making mortgage loans. The customer was now able to get from other institutions money transmission facilities combined with a savings account, and the mortgage loan was increasingly being sold in conjunction with other products such as estate agency services, unsecured loans and insurance services. Building societies attempted to respond to this new competitive situation by widening the range of services which they offered. A number offered cheque book accounts in conjunction with banks, but these accounts could never be as effective as bank accounts, because societies were legally prohibited from offering overdraft facilities, and therefore could not offer cheque guarantee cards. Societies also extended the range of insurance services which they offered, but again they were limited by statute, because they could arrange insurance only in conjunction with the mortgage loan.

By the early 1980s, detailed consideration was being given to the content of new building society legislation. The Building Societies Association published a discussion document in January 1983, and then definitive proposals early in 1984. In July of that year the government published its own proposals in a green paper, *Building Societies: A New Framework* (Cmnd 9316). Like the Association's proposals this argued that societies should remain as mutual housing finance institutions, but that they should be allowed a wider range of powers in order to meet competition. Extensive consultations between government and building societies followed, culminating with the publication in December 1985 of the Building Societies Bill, and after a relatively easy passage through Parliament this became law as the Building Societies Act 1986 in July 1986. Most of the provisions of the Act came into effect at the beginning of 1987.

The 1986 Act: new powers

Under the Building Societies Act 1962, building societies could lend only on the security of land, and their remaining assets had either to be their own office premises, or liquid assets held in a range of closely defined government and government backed securities and

bank accounts. The 1986 Act introduces the concept of commercial assets, broadly speaking, total assets less liquid assets and fixed assets. At least 90 per cent of a society's commercial assets must be in the form of first mortgage loans to owner-occupiers of residential property. Within the remaining 10 per cent not more than 5 per cent can be in the form of unsecured loans, ownership of land and property for residential purposes and investment in subsidiaries and associates, which for the most part are able to do only those things which the societies themselves can do. The significant asset holding power is that to make unsecured loans. Societies have a natural place in this market, in particular for loans connected with house purchase loans, where previously societies have had little choice but to refer their mortgage borrowers who wanted additional finance for furniture and fittings to banks or finance houses. The power to make unsecured loans will also assist societies to offer other financial services such as credit cards and money transmission accounts.

A significant part of the Act is the power to provide a range of services which are listed in Schedule 8. These services, broadly speaking, comprise the whole range of financial and house buying services:

- Money transmission services;
- Foreign exchange services;
- Making or receiving of payments as agents;
- Management as agents of mortgage investments;
- Management as agents of land;
- Arranging for the provision of services relating to the acquisition or disposal of investments;
- Establishment and management of personal equity plans;
- Arranging for the provision of credit to individuals and services in connection with loan agreements;
- Establishment and management of personal pension schemes;
- Arranging for the provision of insurance of any description;
- Giving advice on insurance of any description;
- Estate agency services;
- Surveys and valuations of land;
- Conveyancing services.

☐ Maintenance of adequate assets in liquid form.

☐ Maintenance of the requisite arrangements for assessing the adequacy of security for advances secured on land.

☐ Maintenance of the requisite accounting records and systems of control of business and of inspection of report.

☐ Direction and management of the society by a sufficient number of persons who are fit and proper to be directors or officers, this to be conducted by them with prudence and integrity.

☐ Conduct of the business with adequate professional skills.

Traditionally, building societies have had to maintain only modest reserves, down to 1.25 per cent of total assets in excess of £1,000 million. This has largely reflected the exceptionally safe nature of building society business. However, there is a general perception that mortgage lending is now less safe than in the past and given also the range of new activities which societies could enter into, new capital requirements were in order. In August 1986, the then Registry of Friendly Societies published a consultation paper, and following consideration of comments on that, the Commission published the definitive requirements in two papers in March 1987. The capital requirements for each society will depend on:

☐ The character of its mortgage book;

☐ The maturity structure of its liquid assets portfolio;

☐ The degree of diversification into new assets;

☐ The extent of investment in fixed assets.

The Commission will make its assessment of the adequacy of a capital of a building society by comparing a standard measure of the available capital with two measures of society's required capital:

☐ The minimum acceptable capital, a level below which a society's capital should never fall;

☐ The desired level of capital, which should be the basis for planning or budgeting purposes, and which should be at least 0·5 per cent above the minimum acceptable capital.

For mortgage loans the required capital backing varies from 1 per cent for first mortgage loans on owner-occupied property where the loan has been outstanding for over five years and where the loan plus any further advance does not exceed 95 per cent of valuation,

to 4 per cent for loans of over 95 per cent of valuation. Class 3 lending, that is unsecured loans, requires capital backing of between 10 per cent and 20 per cent, and property for residential development requires a backing of between 20 per cent and 50 per cent. Fixed assets require a capital backing of 50 per cent.

The figures mean that, on average, societies will be required to hold capital of about 3.75 per cent. Most societies are comfortably in excess of this level and over the past few years have been building up their capital in anticipation of the new Act. Moreover, the Commission has indicated its willingness to allow societies to raise secondary capital through subordinated debt issues.

The Financial Services Act

At the same time as the building society legislation was passing through Parliament, other major legislation, ultimately to become the Financial Services Act 1986, was also being considered. This Act sets up a completely new framework for the supervision of investment business, which is defined by the Act in such a way as to exclude the taking of shares and deposits, but to include most other investment business done by banks and building societies, such as the giving of financial advice, the sale of life insurance and unit trusts, and also the sale of the new style personal pensions which will become available from 1988. Building societies are therefore subject to the provisions of the Act.

The implementation of the Act is largely in the hands of the Securities and Investments Board (SIB), to which the Department of Trade and Industry has delegated some of its regulatory powers. In order to undertake investment business an institution has to be authorised, either directly by the Securities and Investments Board, or by one of five self regulatory organisations (SROs). Financial conglomerates such as banks and building societies do not sit happily within the framework for SROs and building societies have indicated that they are likely to seek direct authorisation from the Securities and Investments Board. Societies have also been successful in securing exemption from the investors' compensation scheme, set up under the Act, on the grounds that because they are mutual institutions, the possibility of an unsecured creditor of an investment business of a society losing money is remote. Societies will also be aiming to be exempted from the capital requirements under the Act given their own supervision by the Building Societies Commission.

One of the key policies adopted by the Securities and Investments Board has been that of polarisation. Under this concept institutions

must either be independent intermediaries selling a range of products, or they must sell only the products of a parent institution or company to which they are tied. This means, for example, that it would not be possible for a bank manager to give advice on a range of investments while at the same time selling the unit trusts of his own bank.

The policy creates a particular problem for building societies because, unlike banks, they are not allowed to undertake life insurance business, nor are they allowed to manage unit trusts (except for the provision of personal pensions). It is, therefore, open to a bank to sell only its own products, but a building society cannot do this. The problem is particularly acute in respect of the new style personal pensions which will come into operation from the beginning of 1988 and which building societies are specifically empowered to offer under their own legislation. Most of the large building societies are expected to become independent intermediaries in respect of investment business, but this will preclude them from selling their own unit trust personal pensions. However, such are the anomalies created by the Securities and Investments Board that a personal pension which is purely a deposit is exempted from the polarisation requirements, and societies may, therefore, be encouraged to promote energetically deposit based personal pensions, even though these may be inappropriate for many of their customers. Societies might also find it possible, within the polarisation policy, to select a particular unit trust personal pension and to brand it with their own name.

The policy of polarisation generally is also likely to mean that greater use is made of other distribution channels, in particular direct mail. However, building societies consider it very unsatisfactory that their branch staff will not be allowed to discuss with their long standing customers the nature of a product which the society is selling.

It remains to be seen how polarisation will work in practice, but the present indications are that the policy is likely to cause confusion, rather than achieve the clarity of status of a salesman which is the present intention. The problem arises from the fact that the Financial Services Act covers only investment as defined in the Act, rather than investment as most people would understand it. Considerable changes to the policy, and possibly to the legislation itself, might be required in the fairly near future.

Conclusion

Generally, the Building Societies Act 1986 can be seen as a stop-gap operation. It allows building societies to continue to act successfully

perhaps for five or even ten years, in a very much changed competitive climate where the barriers between markets and institutions are virtually being abolished. The capital requirements of building societies are being brought more into line with those of banks, although there are still differences between the two types of institution, very much reflecting the specialised nature of building societies compared with the general nature of banking institutions. The Act does provide for building societies to convert to company status, and thereby become banks, but it is not generally expected that more than a handful of building societies, if any, will attempt this course of action. With rapidly changing markets and the need to ensure fair competition between institutions, however, the convergence of the systems for regulating institutions can be expected to continue and it may be that within five or ten years the case for separate building society legislation will have reduced, to such an extent that new primary legislation will be required. This might, perhaps, take the form of the recent legislation in New Zealand which removes all of the previous constraints on the activity of building societies in that country.

Biographical note

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