

## **The Nature and Role of Building Societies**

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### **1. Introduction**

Building societies are financial institutions which were developed specifically to fund owner-occupied housing. As such for many decades they were the main institutions within the special circuit of housing finance – based on tight regulation and government constraints on the one hand and tax breaks and restricted opportunities for consumer saving on the other. In the deregulated world that developed after 1980 they have been integrated more closely into the overall financial system, while still remaining highly specialised mutual institutions. They play a continuing but relatively limited role taking in retail deposits and wholesale funding and using these almost entirely to fund house purchase against the security of the dwelling, both owner-occupied and privately rented.

The Building Societies Association, their trade organisation, give the following clarification of how building societies differ from banks (Building Societies Association website).

“A building society is a mutual institution. This means that most people who have a savings account, or mortgage, are members and have certain rights to vote and receive information, as well as to attend and speak at meetings. Each member has one vote, regardless of how much money they have invested or borrowed or how many accounts they may have. Each building society has a board of directors who run the society and who are responsible for setting its strategy.

Building societies are different from banks, which are companies (normally listed on the stock market) and are therefore owned by, and run for, their shareholders. Societies have no external shareholders requiring dividends and are not companies. This normally enables them to run on lower costs and offer cheaper mortgages, better rates of interest on savings and better levels of service than their competitors.

The other major difference between building societies and banks is that there is a limit on the proportion of their funds that building societies can raise from the wholesale money markets. A building society may not raise more than 50% of its funds from the wholesale markets. The average proportion of funds raised by building societies from the wholesale markets is 30%.”

### **2. A short history**

Building societies were developed as friendly societies from the second half of the eighteenth century (Boleat, 1982). The original ones were terminating societies – in

that they were set up by a limited group of people who provided the funds, and often the labour, to build their own homes and remained in existence only until they had provided a home for every member. The first was established in Birmingham in 1775 and the idea spread fairly across the Midlands and the North. They were inherently very local.

In the early nineteenth century societies began to pay interest to people who were willing to invest without requiring a house. Their average size grew from under 20 to between 100 – 200 members. Over the years they moved slowly to becoming financial institutions that took in savings and paid out interest to those savers and used the funds to lend to their members directly to build or to buy their homes from a specialist builder.

The first legislation concerned with building societies was the Regulation of Benefit Building Societies in 1836, establishing a certifying barrister – later the Registrar of Friendly Societies – to register their rules and offer advice. This was followed by the first comprehensive Building Societies Act in 1874 which delineated their powers, notably constraining their activities specifically to building and owning housing rather than lending for broader purposes.

The numbers of building societies increased throughout the nineteenth century so that by the turn of the century there were some 3,650 societies. Thereafter their numbers fell, mainly because existing terminating societies terminated and the terminating building society model no longer appealed as alternatives became available. The result was a smaller number of larger institutions.

During the interwar period the numbers of societies fell to under a thousand. At the same time the role and importance of building societies grew rapidly, aided by low interest rates and rent controls which made building for rent uneconomic. The number of savers grew from 625,000 in 1918 to 2 million in 1939. The number of borrowers increased from 500,000 to 1.5 million over the same period. As such building societies were an important instrument in the government's policy of building 'homes fit for heroes' mainly in the owner-occupied sector. There were however continuing problems of stability and competence. These resulted in the 1939 Building Societies Act which constrained the security that building societies could lend against to first charges on residential property.

Post war, from 1959, the government put funding into building societies to assist lending on older units as well as to help fund new development. Societies were given Trustee status enabling them to take in trustee funds – giving them both considerable respectability and access to large scale funding. Building societies were the main location for individual households' savings, especially if they expected to buy their home or wanted to help their children to do so. The concept of membership remained core to the movement – so established members were often given preference when funding was limited. Moreover both the tax and regulatory framework benefitted tax paying savers as compared to other retail institutions, notably banks. On the other hand building societies remained as friendly societies so could not distribute profits. Instead they were simply added to reserves.

Within this highly regulated framework there was little need for innovation. The majority of societies remained local or regional. Mortgage allocations were made on the basis of local knowledge and often personal knowledge of the dwelling and the

mortgagor; on conservative loan to value and income ratios; and simple twenty to twenty-five year variable rate annuity mortgages. Savers equally received a vanilla product at interest rates which were not intended to clear the market. Overall therefore it was a simple process lending to secure borrowers and receiving savings from conservative savers (remembering there were few other options for savers at that time).

The 1960 Building Societies Act, closely followed by the Building Societies Act 1962 which consolidated earlier legislation, set the scene for very rapid growth in their activities but continued decline in the number of societies. The Act concentrated on clarifying, and limiting, where liquid funds could be invested – extremely important in an industry which was basically borrowing short term from individual savers and lending long term to mortgagors. It also stopped large scale lending to corporate bodies.

Throughout the 1960s and 1970s building societies were the engine by which house purchase was enabled. Many societies broadened their horizons and became more regional; a small number were national (Boleat & Coles, 1987). They were subject to considerable government intervention in setting interest rates and in return were favoured by the tax system. The general principle was that savings rates were supported by a ‘composite tax rate’, reflecting the average tax paid by savers. So tax paying members benefitted at the expense of non tax payers. Mortgage rates were also held below market rates and lending continued to be based on conservative rules and past savings. As such the building society industry was a very safe haven for funds – although not at the highest interest rates. They also lent only to relatively secure borrowers who were well able to afford repayments. Those who obtained a building society mortgage did very well. Those potential borrowers who were excluded had few options, all of which were more expensive.

During the mid 1970s the government introduced a Joint Advisory Committee to agree savings and lending rates at regular meetings between lenders and government (Whitehead, 1970). This was part of general anti-inflationary policy but made the extent of the special circuit of housing finance far more transparent.

In 1980 building societies held 80% of mortgage balances outstanding and provided 78% of the value of loans in that year. This position came to an end in the early 1980s after the controls (corset) on bank lending were removed in 1980, enabling banks effectively to compete for retail funds. Bank lending rose rapidly thereafter. The 1986 Building Societies Act in turn gave societies the capacity to compete against banks by enabling them to lend, an initially very limited, proportion of their funds without residential first charge security and giving them the capacity to borrow some part of their funds from the wholesale market. However these powers did not stop the relative decline of building societies in the market (for a broader perspective on changes in mortgage markets see Coles & Hardt, 2000).

After 1980 and particularly the 1986 Act the housing finance market was integrated into the broader finance market which was itself being deregulated and globalised. Large numbers of foreign banks as well as wholesale funders entered the market. On the lending side the range of mortgage instruments increased. In particular endowment mortgages introduced in the early 1970s because of tax benefits became

very popular. However variable interest rate mortgages continued to dominate (Whitehead, 1989).

The 1986 Act also gave societies the opportunity to transfer out of their mutual status and themselves become banks, giving them an opportunity to distribute reserves to their members at the time of transfer. As many societies had large reserves this was seen as desirable by many members. The first such transfer occurred in 1989. After nearly another decade a number of other building societies followed suit (BSA, 2008). Table 1 lists the main transfers that have occurred.

**Table 1: Building societies taken over by Banks – to September 2008**

<b>Bradford &amp; Bingley</b>	floated 4 December 2000. Mortgage book nationalised September 2008. Retail savings transferred to Abbey (Banco Santander) September 2008
<b>Birmingham Midshires</b>	taken over by Halifax, April 1999. Now a division of Bank of Scotland, which agreed, in September 2008, to be taken over by Lloyds Bank.
<b>Northern Rock</b>	floated 1 October 1997, currently in temporary public ownership.
<b>Bristol &amp; West</b>	taken over by Bank of Ireland, 28 July 1997. Bristol & West transferred its branch network and savings business to Britannia Building Society on 21 September 2005.
<b>Woolwich</b>	floated 7 July 1997, taken over by Barclays Bank in October 2000. Now exists only as a trading name of Barclays.
<b>Halifax</b>	floated 2 June 1997, merged with Bank of Scotland to form HBOS in 2001. In September 2008 Lloyds Bank agreed to take over HBOS.
<b>Alliance &amp; Leicester</b>	floated 21 April 1997, acquired by Banco Santander Central Hispano in October 2008.
<b>National &amp; Provincial</b>	taken over by Abbey National, 5 August 1996 (ceased trading under this name).
<b>Cheltenham &amp; Gloucester</b>	taken over by Lloyds Bank, 1 August 1995. Now exists only as a trading name of the Lloyds TSB Group.
<b>Abbey National</b>	floated 12 July 1989, acquired by Banco Santander Central Hispano in November 2004.

Other building societies merged to become larger, financially stronger and more broadly based. All but one of those that became banks has now merged with or been taken over by larger more diversified banks, many in the last few months. The other

has been nationalised. There has lately also been an increase in mergers between societies – some of which have been ‘enabled’ to ensure survival. Even so by 2007 only one society was among the top ten lenders (Boleat, 2008).

### **3. The legal framework**

The law provides that building societies are a special form of institution. The purpose for which a society can be established is ‘to raise, by subscription of the members, funds for making advances to members out of these funds of the society upon security by way of mortgage or freehold or leasehold estate’. They are thus mutual organisations owned by investing members, that is both shareholders and borrowing members. They cannot distribute surpluses.

Until the 1986 Act the operations of societies were closely circumscribed, limiting them to their basic functions of accepting investments from the public and making loans to home buyers. Surplus funds had to be invested in a narrow range of products, notably government and other public sector securities. Societies could not hold land except for the purpose of conducting their business. Building Societies Acts up to that time were mainly aimed at ensuring lower risks and a greater chance of survival. As such they mainly increased constraints on building society activities while giving them access to low cost funding.

In the face of the deregulation of the banks in 1980 and the more general opening up of the finance system to world competition, the legal and regulatory framework was changed to enable building societies to compete in the new market. The 1986 Act gave them much wider powers both to lend more and for different purposes and to raise funds to support that lending. A new Building Societies Commission was set up, replacing the Registrar of Friendly Societies. Eighty per cent of funds still had to come from retail sources – but this enabled societies to access wholesale funding at the margin. Assets were divided into three classes: first mortgages; other wholly secured debt; and unsecured debt. The proportions of the second and third classes remained very limited. Because of these restrictions it has not been possible for a building society to remain as a society and to be controlled by another type of organisation. They can of course merge with one another but demutualisation, enabled by the 1986 Act, remains the only way of avoiding these tight restrictions.

The 1986 Act still forms the basis for regulation of societies. It has been amended on numerous occasions notably in the Building Societies Act 1997 and the Financial Services and Markets Act 2000, mainly to provide them with greater flexibility.

The 1986 Act still determines:

- the constitution of building societies,
- the limits on raising funds other from individuals and on lending other than fully secured on residential property, and other powers;
- certain powers of the Financial Services Authority;
- the management of building societies, accounts and audit;
- mergers and transfers of societies.

Overall regulatory control passed to the Financial Services Authority (FSA) in the 2000 Act which includes provisions relating to:

- the powers of the FSA;
- regulated activities;
- authorisation and permission;
- approved persons;
- rules and guidance;
- the Financial Services Compensation Scheme – which now covers individual savings up to £50,000 per registered organisation funded by the financial institutions;
- the Financial Ombudsman Service.

The latest legislation The Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 is secondary enabling legislation. The objective is to:

- increase the non-member funding limit to 75%;
- clarify the ranking of shareholders' and depositors' funds equally in the unlikely event of a building society being wound up or dissolved; and
- an easing of rules on mergers between different types of financial mutuals.

Overall building societies remain very different from other financial institutions, not only because of their mutual status but particularly in their emphasis on retail funding and on the security of both borrowing and lending. However societies have also expanded their range of activities and taken on some risks which would more traditionally have been taken by more diversified banks.

#### 4. Some current statistics

Table 2 sets out some key summary statistics for the Building Societies sector. These reflect a continuing decline in the numbers of societies.

**Table 2: Key Summary statistics August 2008**

Number of building societies	59
Total Assets	£360bn
Mortgage Assets	£250bn
Savings Balances	£235bn

Source: BSA

At the end of 2007 there were 59 building societies following the merger of Nationwide and Portman. There were three mergers between societies in 2006, and six mergers in total in the previous seven years. The recently announced merger between Chelsea and Catholic suggests that the consolidation of the sector will continue.

#### *Savings*

At the end of 2007, over 23 million investing members had savings accounts with building societies. However, large numbers of investors have accounts with more than one society, so the number of individuals investing with building societies is well below this figure.

Building societies raised £41.9 billion of funding in 2007, compared to £27.5 billion in 2006. Just under half of the year's funding was raised in the final quarter of 2007, when investors were moving money out of the failing Northern Rock bank.

Retail funding, as opposed to wholesale, contributed just over half (54%) of total new funds available to societies in the 2007 calendar year, compared to 51% in 2006. At the end of 2007, 31% of the outstanding stock of building society funding was from wholesale sources. This is a slight increase on the 29% at the end of 2006.

### *Mortgages*

Building societies had more than 2.9 million borrowers at the end of the financial year 2007. Total lending in that year was £75 billion, up 16.8% on the amount lent in 2006. According to the FSA, building societies and their subsidiaries had a 20.1% share of all net lending in 2007, greater than their 18.5% share in 2006.

The majority of mortgage lending by societies in 2007 was at fixed or capped rates. At the end of 2007 62% of balances were on fixed or capped rates, compared to 55% at the end of 2006. These mortgages would only be fixed for a short period, mainly two years and under and would then have to be renegotiated.

### *Market Share*

Table 3 provides evidence on building societies market share. It shows that while balances outstanding have increased by over two thirds, the proportion of total mortgage balances continues to decline. The same is true for the share of mortgage advances which fell from 16% in 2002 to 14% in mid-2008. In both cases this reflects the growth of specialist lenders and securitisation.

**Table 3: Market Share of Building Societies**

Residential Mortgages	Balances Outstanding £m					
	Building Societies	Banks	Other Mortgage (incl. society securitisations etc.)	Specialist Lenders building subsidiaries,	Other	Total
End of year 2002	123,638 (18.3%)	467,601 (69.3%)	81,834 (12.17%)		2,099 (0.3%)	675,172
July 2008	206,348 (16.9%)	635,130 (52.2%)	372,670 (30.6%)		3,385 (0.3%)	1,217,533

Source: BSA

Table 4 gives the position of the top ten Building Societies as at the end of 2007. It shows that only the Nationwide is a truly major player in the market although five are

in the top twenty. It should be noted in this context that the top 4 mortgage providers accounted for almost half of all lending.

**Table 4: Total mortgage balances outstanding end year 2007**

Rank 2007	Name of Group	£bn	Estimated market share
2	Nationwide BS	118.9	10.0%
12	Britannia BS	23.4	2.0%
13	Yorkshire BS	15.4	1.3%
15	Coventry BS	11.7	1.0%
19	Chelsea BS	9.8	0.8%
21	Skipton BS	8.4	0.7%
23	Leeds BS	6.4	0.5%
25=	West Bromwich BS	5.2	0.4%
25=	Derbyshire BS	5.2	0.4%
27	Principality BS	4.0	0.3%

Source: CML

## 5. Concluding comments

Building societies have had a long and important history providing housing finance in England. However since deregulation most building societies have not been able to hold their own in the globalised market. Many have simply been transposed into banks – where they have proved to be inadequately diversified to survive the current financial crises. Others are now seeking to merge in order to survive.

Even so the fundamentals – of mutual organisations owned by their borrowers and depositors carries with it an ethos of security and risk aversion which is currently appealing. In this context, many commentators are suggesting that the building society concept will increasingly be seen as a sustainable model in the new environment. However some smaller societies are finding it hard to cope and only Nationwide is really in a position significantly to profit from the current environment and to make a major contribution to mortgage lending.

Lending is now so low that it is not possible sensibly to predict the likely market share of building societies over the next few months, let alone years. In October 2008 gross lending and approvals were down by 30% over the same period last year. This is less than for the banks but as year so far their market share has not significantly increased and is running at about 20%. Their position could improve in 2009 as more savings are channelled towards them and the retail funding dominates at least in the short term – but it is inherently from a low base and not one which can be readily expanded. The issue of borrowing short and lending long in the retail market remains a major problem for long term stability.

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