Mutual Chief Executive Opinion Survey 2010

development
pricing
increasing
funds
business
continue sufficient
competition change
product offer
margin
low rate
increase squeeze banks savings
funding
investment
ensure overload need products
attracting
wholesale careful
interest
lending
acceptable mortgage
regulatory regulation liquidity
control
costs capital
retail cost
new

Building Societies Association

Mutual Chief Executive Opinion Survey 2010

This survey of Chief Executives of mutual lenders and deposit takers was conducted by the BSA in mid-March 2010. 33 out of 53 institutions responded, representing almost three quarters of the sector's assets.

Chief Executives' opinions were sought on the following areas:

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Cover image: Word cloud based on challenges in the year ahead

The outlook for the year ahead

Many Chief Executives acknowledge that the next year is going to be very difficult, but in contrast to the last two years, they feel they are less at the mercy of events beyond their control than they were a year ago, though the General Election has added an element of unwelcome uncertainty. Further, many think that they have weathered the past few years relatively well. As a result, 58% say they are optimistic about the year ahead.

"There is an opportunity for a small local mutual to succeed in a market where larger PLC competitors are discredited and wounded. Our people and our member trust can propel us forward."

However, a number of **major challenges** remain:

Margin pressure: Chief among the challenges faced by the sector is the pressure on margins due to the unprecedented low level of the Bank Rate. Virtually all Chief Executives mentioned this directly.

While Chief Executives understand the need for strongly accommodative monetary policy in the current economic climate and the support this provides to borrowers, it is important to recognise one consequence of the near-zero level of Bank Rate is that it severely squeezes the profitability of mutuals' operating models.

Funding: Related to the pressure on margins is the difficulty of raising funding at a reasonable cost. Conditions in the wholesale markets remain tight for all financial institutions. This has a knock on effect on the market for retail savings**,** where competition is intense. Banks that are backed by the state are considered to have an unfair advantage.

Regulatory change: All financial services providers face a raft of regulatory change including greater liquidity requirements, capital requirements, the Mortgage Market Review and the Building Society Sourcebook, the last of which is specific to the building society sector. Adapting to these new requirements will inevitably have costs, further reducing the ability to lend.

Lending: The opportunities to lend at sufficient margin are limited, and with the risk of further deterioration in economic conditions, mutual lenders have to select the segments of the market that they enter carefully.

Other areas that present challenges include the continued management of the relatively few non-performing loans, ongoing cost reduction, and in the face of this necessary austerity, retaining and motivating staff.

"With base rate not looking likely to increase, combined with the pressure to attract and retain retail funding, our margins will be squeezed even harder and tough decisions will need to be made to protect the long-term future of the society."

Market Conditions

Housing and mortgage markets:

The relative recovery in house prices observed in 2009 was largely attributed to the balance of supply and demand in the short term. A shortage of properties came to market, partly because record low interest rates helped borrowers to stay in their homes, while buyers who had sizeable deposits were able to obtain mortgages at attractive rates of interest.

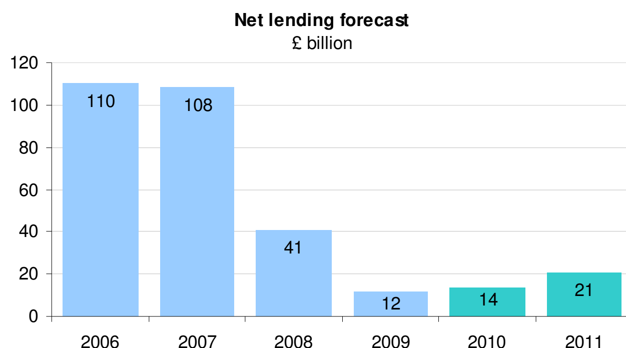
House price growth in 2010: +1%

Bank Rate end 2010: 0.8%
Bank Rate end 2011: 2.2%

However, the majority of Chief Executives doubted whether the increase in prices observed in 2009 could be sustained, as sellers were beginning to return to the market, reducing the upward pressure on prices. If interest rates were to increase, there could be a substantial increase in forced sales which could result in price falls. However, respondents expected the Bank of England to keep interest rates low, with an average forecast of 0.83% at the end of 2010 and rising to 2.17% by the end of 2011, and accordingly many Chief Executives expected little or no house price growth in 2010. The average prediction was a rise of 1%.

"Long-term fundamentals, such as the house prices to earnings ratio, indicate that UK housing is still over-priced, suggesting that we are likely to see either a further drop in prices or, at best, a period of very sluggish growth."

Longer term, some Chief Executives believe that property is over-priced. However, the consensus is that a sudden and substantial drop in prices is less likely than a **prolonged period of house prices showing little growth or slight falls**.



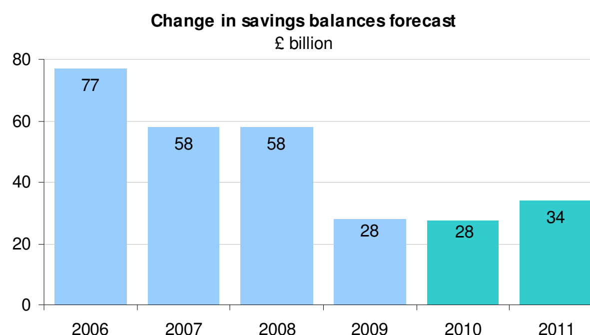
Tight funding conditions were expected to result in mortgage availability remaining low. Net mortgage lending across the UK was £12 billion in 2009. Chief Executives predicted, on average, that net lending in 2010 would amount to £14 billion, and £21 billion in 2011. These amounts are relatively low compared to prior years.

Respondents expect demand for fixed rate products to remain strong as borrowers attempt to lock in relatively low interest rates.

"We are looking to encourage more Guarantor Mortgages in recognition of the difficulties confronting first-time buyers seeking to enter the market."

Savings market:

Competition for retail savings has been intense since the closure of the wholesale funding markets, while low income growth and rising unemployment have reduced people's ability to save. Having risen by £58 billion in 2008, total retail savings balances across the UK increased by just £28 billion in 2009. On average, Chief Executives thought that balances would grow by the same amount, £28 billion, in 2010. In the following year, an increase in balances of £34 billion was predicted.



As mentioned previously, this low level of savings inflows means there are relatively fewer funds for mortgage lending. If institutions cannot attract sufficient funds, they may have to reduce the size of their businesses.

"Intense competition is OK, but a level playing field with Lloyds Group and RBS/Natwest would be welcome."

Respondents said that they did not object to competition for retail savings, as long as it was fair. However, many chief executives viewed the conduct of **Government-backed banks and NS&I as distortionary**, based on the ultra-competitive rates they have offered recently and the perception that they are safer because of the Government's direct backing. Respondents were aware that competition for retail savings will potentially become even more intense as the liquidity and funding support provided by the Tripartite through the crisis is withdrawn.

Some mutuals have responded to the difficult market by exploring new channels or market segments to attract new funds, although many acknowledged that retention of existing savers is key. If the Bank Rate were higher it would make attracting funds easier, and would reduce the pressure on retail margins.

In the difficult economic environment, Chief Executives expected fixed rate products to be popular, but if rates begin to rise variable rates would quickly take precedent. With the tax burden expected to rise, tax exempt accounts are likely to become more popular.

"Headline, short-term offers with restrictive terms continue to attract the public's attention - consistency, transparency and fairness should be promoted."

Government and regulatory policy

Capital

The majority of Chief Executives viewed new forms of capital for mutuals that would count towards Core Tier 1 capital as important to the sector, with 81% saying that such instruments were very important or quite important. The Treasury has published a discussion paper that recognises the issues involved in developing a new form of capital that is attractive to investors but that does not compromise the mutual model, while also complying with forthcoming European requirements. The BSA will be responding to the discussion paper.

"We need a capital raising instrument that allows mutuals to access capital in a form that does not impact on the very essence of mutuality."

Withdrawal of funding and liquidity support

Respondents were asked how they thought the Tripartite should best withdraw the extraordinary measures introduced to provide liquidity support during the last couple of years. Hundreds of billions of pounds of funding was provided to financial markets via the Special Liquidity and the Credit Guarantee Schemes.

Respondents stressed that the withdrawal must be **gradual**, possibly over a longer timescale than is currently planned, and only if the economic context is suitably robust. The effect of withdrawing the schemes should be **closely monitored**, considering the secondary impacts (such as heightened retail savings competition) as well as the direct effects. Furthermore, shocks should be avoided, with one Chief Executive suggesting that a monthly timetable for the next three years be published. **Communication** is considered very important, between the Tripartite so that all are aware of the effects of withdrawing the scheme, but also with the public and media, so that these groups understand that a short-term consequence of withdrawing the funding schemes will be to constrain mortgage availability.

Regarding any specific effects on mutuals, the Chief Executives requested a level playing-field, in that any additional support or the way in which the withdrawal is managed should not unfairly benefit large banks. However, many smaller building societies felt that they had not made use of the schemes during the crisis, so were not likely to be directly affected by their withdrawal.

Mortgage Market Review

Respondents thought that the FSA's Mortgage Market Review (MMR) would have **at best no impact on the mortgage market, and possibly a negative impact**. This would arise from increased costs of compliance for lenders, which would result in more expensive mortgages. The MMR may also reduce innovation, and it risks cutting out self-employed borrowers that could otherwise afford a mortgage. The MMR also causes arrears to be viewed by the regulator as customer detriment, which may result in lenders being more risk averse such that more people are excluded from the mortgage market.

"[The MMR] may place societies at a disadvantage. A great deal will depend on the ability to carry out the required range of activities within Specialist Sourcebook approvals"

Financial Services Compensation Scheme

Mutuals had to pay a disproportionate fee to the Financial Services Compensation Scheme (FSCS) for the rescue of several banking groups during the financial crisis, which squeezed their profits further. As a result of provisions for the FSCS levy, building society profits before tax in 2008/09 accounts were 64% lower than they otherwise would have been.

Although this issue did not ignite passions as strongly as in last year's survey, the impact of the FSCS levies was perhaps clearer, with 60% saying that mortgage rates were higher and savings rates were lower as a direct result, 37% said they had cancelled or postponed projects, and 30% saying they had reduced their investment in staff.

Post Office or People's Bank

Responses were received before the Government's announcement at the end of March 2010, before which the expansion of the Post Office's banking operations represented a minor concern to Chief Executives. Just 13% said they were very concerned by the proposals, and 53% said they were quite concerned. Another 34% said that they were not concerned at all.

"Competition is a good thing if it's not unfair"

It was recognised that the Post Office Bank might be able to fill a gap in the market by providing basic bank accounts and other utility products that cannot be provided on a commercially viable basis. What would be unfair is if the Post Office Bank received a subsidy or was otherwise able to compete on beneficial terms compared to building societies. However, low standards of service might be a barrier to the Post Office attracting customers and the Bank of Ireland, the provider of many of the Post Office's financial services, is backed by the Irish Government rather than the UK's Financial Services Compensation Scheme.

"Much will depend on the levels of advice and service available at these outlets."

Shared Services

Although many Chief Executives saw potential in theory in mutuals sharing services, most acknowledged that practical difficulties were likely to limit the extent to which institutions were able to share services beyond outsourcing of certain support functions. However, there was an appetite for all potential avenues to be explored in case any cost savings could be identified.

Mutuality

What should the new Government do for mutuals?

Chief Executives were asked what one thing the new Government could do to support the mutual sector. Most asked for **fair treatment for mutuals,** including regulation that is proportionate to the risks posed by mutuals to the financial system relative to other firms, and the removal of support benefitting State-backed institutions. Fundamentally, this requires the Government to recognise and communicate that mutuals make a valuable contribution to society and are not a poor relation to plc banks. This needs to feed through into the actions of the FSA and the Bank of England who are perceived by Chief Executives to consider mutuals as an afterthought to policy which is formulated primarily to apply to large banks.

"Stop treating mutuals as an inferior version of the PLC model and recognise us for our own merits. A tailored and proportionate regulatory framework would help too."

Other things that would help would address some of the immediate challenges faced by mutuals included an increase in the Bank Rate, and careful management of the withdrawal of support for the wholesale funding markets. Another recommendation was to make it easier to set up new financial mutuals.

All the main political parties have stated in recent months how they value the diversity provided by the various mutual models of ownership. Chief Executives would like to see some of these warm words translated into action.

Consolidation

Further consolidation in the sector was seen as inevitable, particularly if the margin pressure from low interest rates persists for an extended period. Societies will have to look at ways to reduce costs further, which may mean greater sharing of services or, in the extreme, to merge with another institution.

"[Consolidation represents the] maturing of contemporary businesses. The main thing is that customers have a viable mutual model that is easy to do business with."

However, many respondents noted that this does not mean that the sector is necessarily weaker, and that societies (and indeed banks) have been consolidating for more than a hundred years. Integration with other types of mutual was unlikely, though, beyond product affiliations.

Conclusion

Relative to the hectic events of a year ago, the Chief Executives of mutual lenders and deposit takers feel more confident about the year ahead. However, considerable challenges remain including record low interest rates and the associated difficulties in attracting funds, political and economic uncertainty, and a myriad of new regulations, with the result that Chief Executives of mutuals are planning for another difficult year ahead.