Building Societies Association

York House
23 Kingsway
London
WC2B 6UJ

Telephone: 020 7520 5900
Fax: 020 7240 5290
www.bsa.org.uk

FINANCING A PRIVATE SECTOR RECOVERY

A response by the Building Societies Association

Introduction

1. The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK, including all 49 UK building societies. Mutual lenders and deposit takers have total assets of over £365 billion and, together with their subsidiaries, hold residential mortgages of almost £235 billion, 19% of the total outstanding in the UK. They hold more than £245 billion of retail deposits, accounting for 21% of all such deposits in the UK. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

2. The Government's Green Paper, *Financing a private sector recovery*, recognises the diversity brought to the market by mutuals, and also some of their main strengths, including their strong role in their local communities, the importance of long-term relationships and their propensity to operate in areas of social and economic deprivation. The Government has asked for views on the role that mutuals could play in facilitating access to finance for business and providing greater choice in financial services.

3. This response does not address directly the questions in the Green Paper, but makes some general comments about the role of mutual lenders and deposit takers in business banking markets.

4. The BSA agrees with the Government that mutuals provide diversity to retail banking, which benefits the market in terms of competition and choice, and also adds to financial stability. These benefits are brought to business banking by some building societies and also more extensively by The Co-operative Bank, where the Corporate division comprises about 18% of the bank's total assets, and where lending to business customers has increased by over 40% over the last three years. However, with the recession some societies have reduced their lending to business in order to focus on core activities.

5. Furthermore, there are a number of barriers to expanding building societies' commercial lending activities. These include legal and regulatory barriers, as well as barriers in terms of the requisite skills and appetite within the organisations. Therefore, while a number of mutuals do lend to businesses, in the absence of considerable changes to legislation, regulation, culture, business models and expertise, existing mutuals as a whole are unlikely to take a large share of these markets. At the margin, mutuals can increase their lending to businesses, including SMEs, over the coming years, but they are likely to apply stringent controls in order to ensure a high quality of lending. And most societies do not offer personal current accounts or money transmission services, so could not easily offer a full business package.

Legislative and regulatory barriers

6. Under the Building Societies Act (1986, amended in 1997), at least 75% of all loans[1] held by building societies and their subsidiaries must be fully secured on residential property. This lending limit constrains the extent to which a building society could legally expand into commercial lending. Furthermore, the regulator has looked unfavourably in the past on cases of commercial lending, even where the society does have the property as security for the loan, as in the case of loans for guest houses and B&Bs. And in his assessment of the failure of Dunfermline Building Society (which had a sizeable commercial loan book) the FSA Chairman expressed how the regulator had repeatedly cautioned building societies with respect to non-residential lending over several preceding years.[2]

7. The new Specialist Sourcebook for Building Societies shows that the FSA considers that non-residential lending is potentially viable in moderation, but that building societies' core competencies lie in retail lending funded from retail sources. Any diversification beyond this will be constrained by the requirement to exhibit to the regulator's satisfaction suitable systems and controls. And this restriction is on top of the lending limit set in the Act. The FSA's standpoint is explained in its consultation on the Sourcebook:

> "Some societies have in recent years sought to pursue strategies other than their traditional business of collecting retail deposits to lend on first residential mortgages. In particular, in order to maintain or increase profitability in a competitive market, some building societies diversified into commercial lending, as well as self certification and non-prime residential mortgage lending.
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> Although potentially a viable strategy (as practised by some societies, in moderation) some of these diversifying societies did not identify and control the associated risks sufficiently well, so that the diversification actually increased their risk profiles. This failure to limit and control risk was largely due to the combination of a historic focus on the housing market, statutory limitations on diversification away from residential mortgages, and in some cases, inadequate risk management skills. …
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> As a result, we have sought to take measures to strengthen the sector, to reduce its future vulnerability to difficult market conditions and to ensure that building societies are appropriately equipped to play a central role in UK retail financial services in the years ahead.
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> Our supervision of building societies is designed to ensure that they have appropriate systems and controls to manage the business they do, both within their core competencies of collecting retail savings to lend on residential first mortgages, and within other areas, if and when they diversify their sources of funding and/or types of lending."[3]

8. The Sourcebook will limit the extent of non-residential lending conducted by building societies, even where notionally "commercial" lending is in fact traditional to a particular society and is justified by its favourable loss experience. For example, the "Limited" lending approach under the Sourcebook requires that policy limits (e.g. in terms of loan-to-value ratios or portfolio size) are applied to prevent the society becoming over-exposed to non-traditional lending. The BSA remains concerned that the Sourcebook will discriminate against societies, constraining their activity while banks are free to diversify their lending. Notwithstanding these concerns, the above passage demonstrates the regulatory position that poses a barrier to building societies should they ever wish to seriously expand their commercial lending.

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[1] The lending limit is based on the total assets of a society (or a society and its subsidiaries) plus provisions for bad and doubtful debts less fixed assets, liquid assets and any long term insurance funds.
[2] http://www.fsa.gov.uk/pubs/other/response_dunfermline.pdf
[3] FSA CP09_17, A Specialist Sourcebook for Building Societies, http://www.fsa.gov.uk/pubs/cp/cp09_17.pdf

Other barriers

9. Building societies were originally founded in the nineteenth century to help people finance home-ownership. Partly as a result of these historical roots and purpose, as well as long-standing restrictions on non-residential lending that have applied to building societies, lending to businesses has tended be secondary to societies' main operations. There are exceptions, where some societies have developed services to businesses in certain niche markets, such as loans for guest houses and B&Bs, as mentioned previously.

10. One area of business lending that building societies have traditionally favoured is the housing association sector. Housing associations are social enterprises that constantly need supplementary private finance for their social housing new-build. This is an area that many societies understand well, and where long-term relationships with local housing associations can be built. Currently, mutuals' lending to housing associations stands at around £9.5 billion, some 4% of their aggregate loan book.

11. However, societies' appetite for expanding aggressively into commercial lending has generally been limited. Consequently, the investment in the specific skills and expertise required for this type of business has been largely peripheral to their operations. Expertise is required in underwriting loans at acquisition, but appropriate skills are also required to manage the assets, particularly in cases when they become impaired. In these cases some societies may outsource the collections to an external specialist, at a cost. The greater size of commercial loans means that the impairment charge when they default is typically much higher than on residential loans.

12. It may also be difficult for societies to monitor the performance of commercial enterprises when the society does not also hold the bank account; instead this is normally held with a large clearing bank.

13. More generally, in the current market environment it is likely that mutuals will stick to their core activities rather than expanding rapidly into new, untested markets.

Conclusion

14. Many mutual lenders and deposit takers do cater for businesses to some extent, with the full service provided by The Co-operative Bank an example of a mutual with considerable presence in these markets. As the economic recovery gains strength opportunities may arise that cause mutuals to look to expand their commercial and corporate lending operations, subject to having the necessary controls and skills in place, and some may choose to invest to develop such capabilities in the future. However, building societies are more constrained than other providers in the amount of lending to business that they can write. Not only would this typically represent a departure from their core lines of business, but it might also be prevented by regulatory action and legal limits.

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