
Feature Article

COMPETITION OR CONTROL?: THE GREEN PAPER ON BUILDING SOCIETIES

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The recently published Green Paper outlining a new framework for building societies provides an interesting opportunity to examine the Government's attitudes towards competition in financial markets while revealing clearly its ambivalence about free markets. Lack of confidence in the competitive process finds expression in a desire to regulate. In contrast to the apparent unpredictability which on occasion results from permitting individuals and institutions to select through the market the most appropriate solution to their financial requirements, regulation and its consequent restriction on choice provides apparent certainty to the legislator. Outcomes may be predicted with considerable accuracy and any deficiencies that arise in the course of time can be corrected by introducing new legislation. Unfortunately regulation may also introduce new anomalies and distortions into the financial system reducing efficiency and growth.

Any improvement in the competitive environment is to be welcomed and to this extent the Green Paper must be applauded. However, it is unfortunate that the progress along the competitive path embodied in that document is so limited. In the absence of a clearly defined theoretical model of financial markets the Paper fails to ask many important questions relevant to competition in such markets and the consequent role and position of the building societies. Implicit in the Green Paper is the idea that housing finance is different from other types of finance. This supposition leads to the recommendation that legislative changes should be limited to little more than tinkering with the

regulations governing building societies. If implemented, societies would be allowed a little more flexibility whilst largely retaining their existing structure.

There seems little to commend in such an approach. The housing finance market over at least the last decade has shown, and continues to exhibit, a striking lack of competition. The Green Paper itself documents this and whilst its suggestions will help to improve competition they do not go far enough.

According to the Green Paper building societies

- (1) offer a safe home for investors money and
- (2) finance the growth of home ownership,

two services which the Government, and indeed most of us, find worthwhile. It is clearly desirable that investors should be able to find safe investments and individuals able to secure funds for purchasing their houses. The interesting question relates not to the provision of these services but whether the building societies are the only or most appropriate means of achieving these objectives.

The competitive ideal is a market in which the surplus funds of savers are redistributed to those with investment opportunities. Funds should be available to any investment that can secure returns greater than the appropriate (risk adjusted)

market rate of return since such investments will increase the stock of wealth. Conversely investments that offer returns lower than the market rate are undesirable since they reduce the stock of wealth. Such investments should find it difficult to attract funding.

Of course this is a simplified picture which ignores the problems posed by social benefits and costs. Nevertheless it can still provide important insights into the workings of financial markets and suggest appropriate policies to encourage economic efficiency. It suggests, for example, that unless there are consequent clear social benefits no investment should be subsidised by securing funding at interest rates below those prevailing (for the same level of risk) in financial markets generally. Such subsidies distort the total pattern of investment by stimulating investment in less profitable areas of the economy. It is equally undesirable to set interest rates above the appropriate market level since this will reduce the total investment in the affected area below the social optimum.

Simple as this idea is can we be sure that it is not being violated in UK financial markets with consequent misallocation of resources? We cannot. It is apparent that the housing market, where the existence of the interest rate cartel is recognised in the Green Paper as inhibiting "the free play of market forces," provides instances of just such distortions and whilst it recommends the removal of this particular impediment to competition other examples abound.

The absence of competition is particularly apparent in the market for large mortgages. The Green Paper recognises the diversity in the structure of mortgage interest rates and notes that most societies charge a premium for larger mortgages. This has "however tended to cost them market share among larger borrowers, as the banks have been able to take advantage of the administrative economies of scale in a smaller number of larger loans and of the good credit standing of many larger borrowers". In other words, in a competitive market large loans should have a lower interest rate than small loans and yet building societies continue to follow policies that distort the allocation of

funds, a clear example of lack of competitive pressure.

A second example, this time of a new distortion that the Green Paper proposes to introduce and of the Government's lack of faith in the market process, is provided by the proposed restriction on societies permitted holdings of liquid assets.

No more than one third of total assets may be held in this form in order to prevent societies investing predominantly in gilt edged and other money market instruments. In a competitive market the societies would only hold such instruments if they offered a higher return for the risk assumed than was available in the housing market. If such a situation persisted the mortgage rate should be allowed to rise to restore equilibrium. Resorting to regulation to force societies to invest in housing artificially depresses the mortgage rate and introduces distortions into the structure of interest rates.

Believers in the competitive process may go further and question the implicit assumption of the Green Paper that existing arrangements should continue - a housing market dominated by one predominant type of institution, the building society, with small incursions from insurance companies and banks to provide a semblance of competition. The Green Paper assumes that there is a need for a financial institution directed at one segment of the financial market. The competitive ideal views the financial system as one large market which finances projects and investments of any sort and where the important characteristic of an investment is **not** its nature but the reward it offers for the risk assumed. In this framework housing is just one of many possible users of funds and it is undesirable that it should be insulated from the forces acting in the market as a whole. It is a matter of indifference whether investors invest in housing or other forms of investment so long as they pay the appropriate rate of interest, just as our concern is not from whom they borrow but rather the total availability of funds. In financial terms there is nothing special about housing finance and in consequence institutions specialising in this sector should be treated in the same manner as other financial institutions. There is no obvious explanation why building societies should be regulated in a significantly

different fashion from clearing banks, for example. Regulation aiming to protect savers and investors from deliberate fraud and mismanagement should not provide a justification for restrictions which severely impede the competitive process. There is also no compelling reason why building societies should be restricted as the Green Paper recommends to being mutual institutions. Other financial sectors such as insurance, encompass both mutual and profit making institutions.

From a financial perspective it is difficult to see any conclusive reason for treating borrowing for housing different from borrowing for other purposes. To argue that housing is an important social objective and therefore **demands** special funding facilities is unreasonable when the poor, and sometimes desperately needy, are forced to borrow (if they can) at very high rates from other credit institutions for equally desirable purposes. Accepting that the growth of home ownership is a worthwhile objective does not imply that the housing finance market should be insulated from other financial markets. While it is important to guarantee the **availability** of loans at current market risk adjusted rates it is equally important not to provide mortgage funds at rates below the current market level since this will distort the flow of resources. The question to be answered is whether there are any aspects of housing finance that suggest that this sector of the financial market should be treated differently. Recent UK experience is an inadequate guide since the banks have had to compete on an unequal footing with the societies in the provision of housing finance. Experience elsewhere suggests that banks and other similar institutions are equally capable of meeting individual requirements.

This is not of course a plea to remove building societies from the ranks of financial institutions but rather to allow any financial institution interested in providing housing finance to do so and **more importantly** to free building societies from the fetters that prevent them competing in other segments of the financial market. Even-handedness requires not just competition in the housing market but in all sectors of financial markets. If building societies, through their extensive retail network, are able to offer consumers a

greater variety or more cost effective services than other institutions then they should be able to do so just as institutions wishing to exploit economies of scale and specialise in a particular sector of the market should be free to do so. The Green Paper does suggest some liberalising of the present constraints on the societies but is reluctant to embrace a truly competitive framework. Apologists of that document may argue that the desire to provide a safe investment for savers constrains the extent of possible changes but this assumes that alternative investments are not available and that financial institutions are necessarily risky. The record of the clearing banks or some of the other institutions clearly indicates the falsity of that proposition.

Amongst the new functions which the Green Paper suggests that societies should be allowed to provide are a more complete range of personal banking and money transmission services to their members. The Paper goes so far as to say "Financial institutions should be able to compete on equal terms in this field". It is far from apparent why this particular financial intermediation function should be singled out. The money transmission system is likely to be expensive to operate and a considerable burden to the societies resulting in a further rise in the ratio of management expenses to assets which the paper notes doubled in the past decade and has only recently shown any sign of falling. In itself the costs associated with extra services are not necessarily bad. The provision of additional facilities may reduce an individual's own adjustment costs - it may be more convenient and cheaper for an individual to deal with one institution rather than several - so that the provision of extra services provides very real benefits to consumers. What is of particular interest is why the Green Paper should perceive the freeing of the restrictions on the money transmission mechanism as of particular importance.

Possibly the most important manner in which the Government could foster competition in financial markets is in the market for loans. Regrettably, it is here that the regulatory habit finds greatest expression. A distinction is proposed in the Green Paper between different types of assets. Building societies would be required to hold at least 90% of their assets in mortgages on

residential property and no more than 5% of their assets in unsecured lending, the ownership of land and property and equity investment. It is not at all apparent why the Green Paper should adopt 90% as its limit on residential property. More appropriate surely than an arbitrary limit would be to lay down guidelines and prohibit societies from rapid changes from those suggested. This would allow societies to change over time and provide much greater flexibility to evolve in a manner appropriate to an individual society's requirements.

The motivation for this division of assets is the laudable aim of protecting investors and savers by restricting the ability of the societies to take on risky assets. In the process, however, they also severely restrict the ability of the societies to compete with the banks. The restriction on unsecured lending, with a suggested limit of £5,000 to any one individual, is unnecessarily restrictive. No well managed institution is going to lend to individuals who have little chance of repayment. Commercial prudence requires lending only to those of good financial standing whilst the risk reduction provided by many borrowers in the case of unsecured lending suggests that many of the restrictions on assets are unnecessary. It is interesting that the document suggests tight control over assets and yet argues, almost as an aside, that the societies may innovate and develop new fund raising instruments - a process that can be extremely risky as Merrill Lynch has been recently finding to its cost.

The last matter we shall address concerns the control and accountability of the societies. The Green Paper sets out three objectives with regard to improving the accountability of the societies: (a) improving the flow of information to interested investor, (b) giving members a greater opportunity to raise points at the AGM and (c) making elections fairer. While these are all worthwhile the Paper may be criticised for not going far enough. Although extra information is to be given to the Registry, for reasons of commercial sensitivity it will not be generally available. There seems no reason why this data should not be published after a lapse of a few years to allow any interested party to consider, in depth, the long term management of a society.

More importantly, the Green Paper accepts with little discussion the mutual form of the societies although this sharpens many of the problems of control. There cannot be any discipline exerted by the market since the societies are not companies and hence not quoted. Few if any analysts monitor their progress, quite unlike the situation for commercial companies. This suggests that the information that societies provide to their investors must in part be comparative and evaluative. Reports emphasising their management expenses, advertising costs and 'profits' together with comparisons with other societies and perhaps other institutions, would allow members to be better informed about their investments. Such information must be coupled with an opening up of the directorships of the societies. Self perpetuating oligarchies are clearly undesirable but how are these to be prevented? One possibility would be for the Government to maintain, much as it does for Quangos, a list of the 'great and the good', qualified individuals prepared to serve as outside directors on the boards of a society for a strictly limited period. It is important to escape from a situation in which friends, acquaintances and business partners of the existing board find their way onto that board. In the absence of shareholder power it is necessary to provide statutory mechanisms for ensuring genuine outside influence on the societies. The vague possibility of being elected, implicit in the Green Paper, is not sufficient. It would be difficult, even with 'even handed' elections, for candidates not endorsed by the board to be selected.

The Green Paper contains many other suggestions worthy of comment. Enough has been said however to indicate the limited progress that the document makes. Moves to let the winds of competition into the housing finance markets are to be welcomed but much more could be usefully done with benefits to all.