Building societies are already within the framework of monetary control

By Tim Congdon *(Economist, L. Messel & Co)*

"Interest rates are vital in attaining money supply targets—but they are also a powerful tool for regulating the level of building society deposits. It follows that there is no need for institutional reform specific to the building societies. As long as the direction and force of monetary policy is conveyed by interest rates, there is no danger that building society share accounts and bank deposits will grow at markedly different rates.

"Because the growth of building society deposits is highly responsive to general interest rate movements, and because administered interest rate charges are the prime instrument of monetary policy, building societies are already effectively within the framework of monetary control.

"The big issues in housing finance relate not to the privileges, alleged or factual, of the societies but rather to the tax subsidies to home purchase and the overt subsidies to rented public housing which now seem to be accepted as inevitable characteristics of the property market. Perhaps a more fundamental topic would be to consider how the role of building societies would change if there were a free housing market and the general price level was stable. They might be much smaller and much less controversial than they are today".

These were among the views expressed by Mr Tim Congdon in a paper given at a seminar organised by Clive Investments in which he considered the argument by the clearing banks that building societies should be included in the monetary control mechanism. He also examined the possibility of a variable minimum liquidity ratio.

The building societies' success in capturing a higher share of deposit-taking business in recent years has aroused envy and criticism. It has been argued that greater power has not been matched by greater responsibility and, in particular, that it is wrong the societies are not subject to the regulations imposed on other financial institutions for the purposes of monetary control. Should new constraints be introduced?

The demand for a new control mechanism has come from two sources. First, the mid-1970s have seen the adoption of money supply targets, expressed in terms of sterling M3, as the centrepiece of financial policy. Sterling M3 consists of notes and coin, and bank deposits. But, because building societies are open on Saturday mornings, their deposits are in some respects more accessible than bank deposits. It has been asked "What sense does it make to include bank deposits in the definition of money but to exclude building society deposits?" if the societies are also acting "as a more or less temporary home for spare cash".[1] Perhaps a wider definition of liquidity, which has been dubbed "M5" and contains building society deposits, should be subject to an official target.

Secondly, the clearing banks have become increasingly jealous of the societies. In its evidence to the Wilson Committee, the Committee of London Clearing Banks focused on what it termed the "important fiscal advantage" given by the composite tax rate arrangements. But, in a section entitled "The need for fair competition", it also referred to their exemption from monetary controls. The banks' complaint was that, although the societies face portfolio constraints, "these are in force for prudential purposes rather than to limit the growth in liabilities". Moreover, the societies have never suffered from the "corset" controls on interest bearing liabilities.[2]

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I shall argue that although alternative control mechanisms should be considered, there is no case for a major upheaval of present arrangements as the societies are already very susceptible to interest rate fluctuations and, hence, to monetary policy.

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It should be said straightaway that the building societies' independence is far from absolute; it is simply not true that they are free from controls over the growth of their balance sheets. The Joint Advisory Committee on Mortgage Finance, set up by agreement between the Building Societies Association and the Government in October 1973, is intended to maintain a stable flow of mortgage funds and, thereby, an orderly housing market. Every six months a lending figure is established with these objectives in mind. Possibly the only occasion when this was irksome to the societies was in March 1978, when the Government requested that net new commitments for house purchase be held down to an average of £610m a month compared with over £700m in the first quarter. But the episode emphasised that constraints do already exist.

JAC mortgage ceiling

The BSA has objected to further controls because "societies' lending is confined to mortgage loans and other loans relevant to housing so that general credit controls would not be appropriate".[3] However, this rather understates the case, as a comparison with the corset, the favourite official instrument for discouraging bank lending, demonstrates. Because the corset applies to interest-bearing eligible liabilities, it does not have a major, immediate and direct effect on banks' profitability.[4] **But a JAC mortgage ceiling, which affects the assets side of the balance sheet, could clearly have unfavourable financial repercussions for building societies. If deposits grew much faster than the permitted rise in mortgage advances, the excess funds would have to be allocated to either "peripheral lending" or to accumulating liquidity. Liquid assets give a lower return than mortgages, while the scope for peripheral lending is not endless. In other words, a JAC mortgage ceiling could do more harm in profit and loss terms to the societies than the corset does to the banks.**

It should also be noted that the corset would need to be redefined almost beyond recognition if applied to the societies since virtually all their liabilities are interest-bearing and it would be necessary to categorise certain liabilities as "eligible", others as not. Since the criterion for eligibility in the banks' case is related to the reserve asset ratio, it is not obvious on what basis such categorisation would be made.

This leads on naturally to the proposal that the societies be subject to a reserve asset ratio discipline similar to the banks. Before discussing the potential impact on the societies, it is worth describing how the ratio—when

administered in the classical "textbook" manner—is supposed to apply to the banks. In every sophisticated financial system, banks have to keep a particular proportion of their assets in instruments whose supply is closely under the control of the central bank; by regulating the quantity of these instruments in existence, the central bank exerts leverage over the banks' entire balance sheets. In the UK, the banks are required to keep 12½% of total assets in the form of certain specified reserve assets (mainly money-at-call with the discount houses and Treasury bills).

Now it might seem that this enables the Bank of England to regulate total assets as, by open market operations, it can alter the quantity of reserve assets held. In fact, the relationship between the Bank and the banks is very different. The Bank regards the adequate provision of reserve assets as essential to stabilising the banking system, and does its utmost to ensure that a reserve asset squeeze never leads to a hurried calling-in of loans. The special deposit mechanism is in theory designed to increase the effectiveness of the reserve asset ratio, but again the Bank emphasises "flexibility" (ie accommodation to banks' existing portfolios) in practice. The true cutting-edge of British monetary policy has very little to do with reserve asset ratios.

A variable minimum liquidity ratio

However, it has been suggested that the ratio be extended to the societies. One consequence would be that "the combined volume of credit would be constrained by the supply of reserve assets, which it is not at present", even if the banks might suffer as there would be a new competitor for holdings of reserve assets.[5] But there are fundamental objections. **The most obvious is that at present few reserve assets fit into building societies' balance sheets: the societies have no established connections with the discount houses and their holdings of Treasury bills are minimal. The Bank of England, the guardian of the financial system, would not consider imposing such an inappropriate ratio.**

Is there an alternative? One may be sought in the societies' liquidity ratio, which is their operational counterpart to the banks' reserve asset ratio. The legal 7½% ratio requirement, supervised by the Registrar of Friendly Societies, is irrelevant, since the volatility of interest rates in recent years has caused societies to keep ratios above 15% almost continuously. But the authorities could consider applying a higher ratio, laid down by the Bank of England, as a minimum proportion of societies' assets.

As a weapon for exerting pressure on societies' balance sheets through the liquidity ratio, open market operations are inapplicable. The assets which comprise the liquidity ratio include some (eg medium-dated gilts, local authority bonds) which are held in large amounts by the general public and a wide range of financial institutions. There is no one instrument which is taken up almost exclusively by the societies and could be transacted for control purposes mainly between them and the Bank (cf the Federal funds market in the USA, where a conventional reserve asset ratio system is operated); and there is no one market where the societies confront the Bank as a matter of routine (cf the discount market in the UK). It would be pointless for the authorities to designate assets in a fixed liquidity ratio of, say, 20% and then alter the availability or price of the assets in order to change building society behaviour. Indeed, it is difficult to see how such a system would work.

There is another, more serious possibility—for the Bank to vary from time to time the minimum liquidity ratio allowed to the societies. It perhaps merits more detailed discussion than some other proposals in this area. The system would operate quite simply. If the societies were receiving inflows so large that they threatened to disrupt the housing market and to create problems of monetary control, the Bank would raise the liquidity ratio. Societies would, therefore, have to reduce the proportion of their inflow committed to mortgage advances. If, on the other hand, inflows were dwindling, the liquidity ratio could be reduced. The precise mechanics might be more complicated. For example, the societies would have to be given time for the adjustment of their portfolios. But there is no obvious flaw on grounds of infeasibility.

It might be asked in what ways this control framework differs from the societies' regulation of their own affairs at present. There is already conscious planning of liquidity ratios, with the aim of smoothing out the impact of inflow fluctuations on mortgage lending. Nevertheless, a variable liquidity ratio does have some good points. It would end the necessity for a mortgage lending ceiling imposed by the Government after JAC consultations. There would be three advantages.

First, the application of a ceiling system for the whole building society movement involves the setting of quotas for individual societies. Potentially this is a delicate issue, since some societies may be experiencing deposit inflows at different rates from others and their initial liquidity situations may also contrast markedly. A minimum ratio applicable to every society would be less discriminatory.

Secondly, because rapid deposits growth by one society at the expense of others would not be penalised, a variable ratio system would permit continued competition between societies. A major drawback to lending ceilings on the banks in the 1960s was that they protected the market shares of slow-growing, inefficient institutions. This consideration was one of the principal motives for the Competition and Credit Control reforms in 1971.

Thirdly, a variable ratio system would not be accompanied by the distortion of societies' desired asset structures by "peripheral lending".

> **In short, the case for a variable minimum liquidity ratio compared with a mortgage lending ceiling is that it is less inflexible, arbitrary and distorting. The argument against is that it corresponds so closely to current practice that there is no need for formalisation and official regulation. There would also be the sensitive political question of whether the ratio was varied after discussions with the buildings societies or "at arms' length" on the discretion of the Bank and the Treasury. Changes in the liquidity ratio would, of course, affect profitability and the societies might be inclined to resist increases.[6]**

Deposits and interest rates

The discussion so far has concentrated on the assets side of the balance sheet. The emphasis is logical enough from the viewpoint of stabilising the housing market, but its relevance for monetary control is less direct. The growth of building society deposits, not mortgage advances, is critical for "M5". There are links between the control mechanisms I have outlined and deposits. For example, an increase in the liquidity ratio due to an unwanted deposit inflow while societies are subject to a JAC ceiling reduces profitability: it might therefore oblige the societies to reduce deposit rates and stem the inflows of new money.

But effects such as this are unlikely to be very strong and are dwarfed by far the most important regulator of building society deposit expansion—fluctuations in the general level of interest rates. The relationships here are familiar and reliable; they constitute the real case against the introduction of new forms of monetary control. They have been described succinctly by Professor David Llewellyn:

> **The rate of interest on (building society) deposits is**

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more stable, and fluctuates within a narrower range, than market interest rates. While movements tend to follow the market trend, the adjustment delay and smaller magnitude of the adjustments imply that the competitive position of the societies improves (worsens) when interest rates in general fall (rise). The societies, therefore, experience a greater inflow of funds when interest rates in general are either low or falling.[7]

The power of these relationships is a fact of life for the societies and, indeed, it could be argued that they are more susceptible to interest rate changes than the majority of financial institutions. Statistical tests on the relation between net inflows and the differential between the gross building society share rate and bank deposit rate (or three-month local authority rate) have a very good "fit": this is one of the few areas in finance where econometrics has generated worthwhile results. It might be expected from these results that the interest rate volatility of recent years would lead to larger fluctuations in inflows—and that is exactly what has happened. **If the Bank of England wants to control the building society component of M5, manipulation of interest rates is sufficient.**

Earlier I outlined the textbook operation of the reserve asset ratio mechanism while noting that its practical application by the Bank of England was much less rigorous. The Bank has many instruments for achieving its monetary objectives, but the principal one is varying Minimum Lending Rate in order to alter the entire structure of market interest rates. Changes in special deposits and discount market operations may make a particular MLR effective, but they do not have an autonomous role in monetary policy. This was recognised by Gordon Richardson, Governor of the Bank of England, in the Mais Lecture early in 1978, in which he said, "We seek to manage the course of the monetary aggregates by bringing about changes in interest rates". The main channels of influence are through the effect of higher interest rates in stimulating gilt sales and deterring loan demand from the private sector.

Interest rates are vital in attaining money supply targets—but, as we argued above, they are also a powerful tool for regulating the level of building society deposits. **It follows that there is no need for institutional reform specific to the building societies. As long as the direction and force of monetary policy is conveyed by interest rates, there is no danger that building society share accounts and bank deposits will grow at markedly different rates.**

Insatiable mortgage demand

One qualification should be inserted. Because of inflation and the tax-deductibility of mortgage interest, there is an insatiable demand for building society advances. The absence of a meaningful market-determined control on the growth of their assets, and not their tax advantages or allegedly unregulated character, is perhaps the real sense in which societies differ from banks. If, over a period of years, inflation subsided to more normal levels and interest rates generally moved down, the societies would not be forced by *market* pressures to reduce their rates in line.

The deterrent against undue bloody-mindedness by the building societies is untimately the *political* pressure which the Government would make effective through the JAC. Given the drawbacks of a lending ceiling described earlier, the case for a variable minimum liquidity ratio might, in such circumstances, become more relevant and interesting. An increase in the minimum liquidity ratio does, of course, lower the profitability of marginal funds and the societies therefore have a financial inducement to reduce their deposit rates. The Bank of England could vary the liquidity ratio to push building society deposit rates into closer alignment with other market rates.

Conclusion

My theme from the viewpoint of the building societies has been rather complacent. Because the growth of building society deposits is highly responsive to general interest rate movements, and because administered interest rate charges are the prime instrument of monetary policy, the building societies are already effectively within the framework of monetary control.

The societies' position is nevertheless anomalous. Personal sector deposits with the building societies are now much higher than those with the banks—and it seems odd in an era of explicit monetary control that it is only the banks who are in the front line of official regulation. Clearly, the building societies will be able to remain free, from monetary controls only if they do not abuse the very considerable power they have. I advanced a proposal for a variable minimum liquity ratio more as a debating point than in recommendation of its adoption, and it might be preferable to the JAC machinery in certain circumstances. But as long as the societies continue to behave responsibly, they need not fear a radical disturbance of present arrangements.

The big issues in housing finance relate not to the privileges, alleged or actual, of the building societies but rather to the tax subsidies to home purchasers and the overt subsidies to rented public housing which now seem to be accepted as inevitable characteristics of the property market. In comparison with the distortions which arise from these subsidies, the problems for monetary control created by the building societies' exemption from the reserve asset ratio or "corset" are trivial. Perhaps a more fundamental topic would be to consider how the role of the building societies would change if there were a free housing market and the general price level was stable. The societies might be much smaller and much less controversial than they are today.

Notes

(1) "Economic Viewpoint" by Rodney Lord in *Daily Telegraph*, 18th December, 1978.
(2) Committee of London Clearing Banks The *London Clearing Banks* Longmans: London 1977 pp 189–190.
(3) The Building Societies Association *Evidence to the Committee to Review the Functioning of Financial Institutions* London 1978 p 7.
(4) This is not to imply that the "corset" does not eventually impair banks' profitability by reducing their competitive position relative to other financial institutions. Indeed, since there is an inevitable departure from desired portfolios, profitability must be affected. But the effect is not big and quick, while the environment of high interest rates in which the "corset" is usually imposed helps banks' profits.
(5) D. T. Llewellyn "Do building societies take deposits away from banks?" *Lloyds Bank Review* January 1979 p 32.
(6) The lower profitability of liquid funds is, of course, not immutable. In fact, interest rates on short-dated gilts and most money market instruments are higher today than the mortgage rate. However, this should be regarded as an exceptional state of affairs and it is contrary to the purpose of the building societies' movement for them to hold excessive liquidity.
(7) D. T. Llewellyn, ibid p 25.