

CHAIRMAN'S ADDRESS

**Text of a speech by Graham Beale, Chairman, The Building Societies Association
and Chief Executive, Nationwide Building Society, to the BSA Annual Lunch,
London – 12 November 2009**

Introduction

I am delighted to welcome you to today's BSA Annual Lunch.

As well as our friends from Parliament, Whitehall, the media, the regulators, other trade bodies and suppliers of services to building societies, I would particularly like to welcome two guests. Our special guest today is Sarah McCarthy-Fry, Exchequer Secretary to the Treasury and Minister for Mutuels, who will be speaking after me. I would also like to thank our sponsor – Legal and General for their generous support of this lunch. Chris Last, General Manager Bank and Building Society Distribution will be addressing us after Sarah.

We are now just a few weeks away from the calendar year end and also for many societies, their financial year end. 2008 will be recorded in history as the year of the financial crisis but in many ways 2009 has been equally challenging for retail funded financial institutions.

The economic and market conditions have been unprecedented which when combined with a raft of regulatory changes, creates an incredibly complex set of circumstances through which we have had to manage our respective businesses. I am going to talk about each of these issues and reflect on the short term and longer term consequences for the building society sector.

So why was 2009 such a difficult year? Firstly, the two principle markets for building societies, mortgages and savings, have both contracted by approximately 2/3rds when compared with 2008 which was itself a lean year.

The savings market has reduced because, in these uncertain times, consumers have paid down debt in preference to saving. In addition, equity withdrawal on the back of rising house prices, has traditionally bolstered the savings market. Of course, this has not happened for two years now as house values have fallen.

Falling house prices have had a negative influence on the housing market and purchase activity and remortgage activity have reduced significantly because borrowers either do not have strong enough credit credentials to borrow or to switch lender or have reverted to rates which are more attractive than current market rates.

So, as a consequence I expect to see a number of societies with contracting balance sheets in line with the contractions in our principal markets.

The second reason why 2009 has been so difficult is the interest rate environment. The fall in base rate to an historic low of 50bp has resulted in a narrowing of margins. The contraction has worsened throughout 2009 as savings rates have repriced at a much faster rate than mortgage and other loan assets.

And the demand for retail deposits has never been greater giving rise to market distortions as institutions refinance their balance sheet in the retail rather than the wholesale market because they have lost their credit rating which gave access to wholesale funds or because they have been encouraged by their regulator to change the profile of their liabilities. The net consequence is that the margin between savings rates and mortgage rates has been eroded.

But the demand for retail deposits is so intense that rates have been pushed up in some cases to uneconomic levels. And this is often by institutions that carry real or implied unlimited guarantees because of their full or part state ownership.

There are a number of consequences for this. Profit levels for most retail funded institutions will fall. Secondly the current level of retail pricing for savings products is not sustainable. Which means that at some point savings rates will fall in relative terms or more likely the cost of borrowing will increase. Neither of the outcomes will be popular but it is a basic commercial reality.

The third reason why 2009 has been a difficult year is the impact of credit failures as the recession starts to bite. There is good news here for most societies because they hold strong, prudently written mortgage loans and credit performance has been strong. However, some buy to let, self certified, acquired and commercial loan portfolios have deteriorated during the year giving rise to higher provisions charges and a further suppression of profits.

So 2009 may see a number of societies recording low levels of profit or even losses. And building societies are not alone in this reduced performance. The retail activities of banks recorded a 78% fall in profits in the first half of 2009 compared with the equivalent period in 2008. Now I have two further important

comments: not all societies have struggled and some will have very strong results for 2009. For others their results need to be considered in context. The economic and market conditions, as I have just described, are unique and not expected to last. Secondly building societies have high levels of reserves – profits built up during the good years to cover precisely the type of circumstances they might now face.

So we need a considered response to the results season. The sector is not in crisis. There may be individual issues but the building society sector as a whole is far better placed than other financial sectors in the UK to tolerate current conditions. Regulators should remember that only one building society has required government support and at a very modest level compared with the billions used to support the banking sector.

I am conscious of time but I want to talk briefly about emerging regulation. And I want to make it clear up front that I understand the need for regulatory and prudential change to prevent a repeat of the financial crisis. So I am not against change but as a practitioner I am finding it increasingly difficult to interpret the effect of the regulatory change currently in process. And my concern is that strategic long term decisions are being put on hold until the landscape becomes clearer... and this stagnation is not good for the UK economy or the evolution of building societies. And there is a very real danger that the law of unintended consequences will prevail.

The regulatory and prudential changes are broad and far reaching. They embrace the structure of balance sheets with regard to liquidity, funding and mortgage assets. There are conduct of business changes affecting mortgages and the distribution of financial products. There are changes to governance and compensation arrangements. This list goes on and on and on.

Societies are resilient and we will work with the regulators to adopt all of these changes. And I suspect that there will be some revisions and even U turns as we work through the consultative process and the consequences are fully understood. But this emerging regulation will come at a cost. There will be disruption as building societies and also banks align to the new rules and there will be significant costs in carrying more liquidity and extending the maturity profile of funding. And I suspect that this cost will ultimately be passed on to consumers in terms of more expensive products. I have already described how profitability is under pressure and there is little scope to tolerate more strain. However of all the issues under debate the most fundamental concern attaches to the proposals regarding capital.

The Tripartite has made it very clear that they want to see a greater quantity and a better quality of capital across the whole of the financial services sector. And this is where the building society sector has a major

issue. We have the strongest and purest levels of capital in the industry but our ability to manufacture higher levels of capital is limited without compromising our mutual status.

In the past organic capital has been supplemented by PIBS at Tier 1 and subordinated debt at Tier 2. The Tripartite are equally clear that capital in the future must be Tier 1 and preferably core Tier 1 and that subordinated debt is effectively redundant as a capital instrument.

So this leaves PIBS and the recently introduced Profit Participating Deferred Shares. PPDS were used by West Bromwich Building Society when they restructured their balance sheet. But there are strong reservations that a market exists for PPDS and they are therefore doubtful as capital instrument for the future.

PIBS on the other hand enjoy an established market. And PIBS are loss absorbing and share many of the characteristics as ordinary share capital. However, unlike ordinary share capital PIBS are regarded as Tier 1 rather than core Tier 1 by the FSA despite legal and practical arguments to the contrary ably put forward by the BSA. There is even suggestion that PIBS may be relegated to Tier 2 capital.

I was delighted when the White Paper earlier this year confirmed a desire to promote a 'healthy and vibrant building society sector'. And the Expert Group formed as a result of the White Paper has three areas of consideration; capital, governance and shared success. The treatment of capital and access to inorganic capital is fundamental to the future of the mutual sector. I wish this expert group every success and would encourage the FSA in particular not to back us into a corner by an over rigid or super equivalent interpretation of the capital requirements directive. Such a policy is, in execution if not intention, anti mutual and we are determined to challenge it.

Before I close I want to briefly comment on why I believe the building society sector is so important to the economy, to the financial services industry and to society. The traditional values of building societies revolve around putting the customer first. This ethos underpins everything that a building society does and provides much needed diversity to the financial services landscape, a point many policy makers appear to be overlooking.

The results are clear to see – more responsible lending with much lower arrears than other mortgage lenders, a longer term focus free from shareholder pressure or the herd instinct of the City, provision of long term good value to consumers; our members, and providing high levels of service.

Lord Adair Turner expressed a view that banks are socially useless. He may or may not be right. What I do know is that building societies are of profound benefit to local communities throughout the UK and society generally. You will find many examples of building societies working with local schools, with housing associations, providing local sponsorship of community activities and charities. Building Societies are extremely proud of their heritage. So building societies are far from being socially useless; in fact they are the exact opposite which is why it is so important that the endorsement in the White Paper of a healthy and vibrant building society sector must be preserved and built upon.

Introduction to Sarah McCarthy-Fry

I am delighted to conclude my remarks by introducing our principal guest, Sarah McCarthy-Fry, Labour Co-operative MP for Portsmouth North, Exchequer Secretary to the Treasury and Minister for Mutuals. She was first elected to Parliament in the 2005 General Election. She has worked as a financial controller for GKN Aerospace Services and also as a financial analyst working abroad in Germany and the USA. Since 2006 she has held various official appointments and became Exchequer Secretary to the Treasury earlier this year. Her website says that her hobbies include tap dancing, dog walking, amateur dramatics and twittering, and she was once a member of MENSA.

While still a backbencher she was an active member of the All Party Group on Building Societies and Financial Mutuals and played an important role in the preparation and publication of the report looking at the true cost of demutualisation which as we have seen over the last couple of years was even greater than those estimated by Sarah and her colleagues when that report was published in 2006.

Sarah, we look forward to hearing what you have to say.....