Executive Insights

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UK Building Societies: Ripe for Reinvention?

Building societies emerged in the late 18th century in the Midlands of England to finance housing construction for members, funded by a central pool of their monthly subscriptions. At their height, there were hundreds of building societies, but over time their numbers decreased through consolidation.

Legal changes in the 1980s allowed them to offer broader banking services and to demutualize; as a result, their distinction from standard retail banks became increasingly blurred and many were acquired by larger commercially run banks.

There now remain just over 40 building societies, collectively with £350 billion of assets, representing a quarter of UK mortgage lending, or about 10% excluding Nationwide, by far the largest player. This share of mortgages is substantial, but has been in steady decline over the past two decades.

Many industry participants now question the sustainability of building societies in the UK, particularly that of the smaller and mid-sized players. Undoubtedly, they face an intensifying range of threats. There are, however, significant opportunities for profitable growth, but for many organizations this will likely require significant refocus or development in the face of marketwide and other changes explained in this *Executive Insights*.

This paper sets out the key challenges facing building societies, highlights five possible business models in the sector and provides a road map for strategic review as a foundation for future success.

Tough times

The market and competitive playing field for building societies are evolving rapidly away from the environment in which they have historically succeeded.

Increasing competitive intensity

The traditional building society model is under increasing pressure from a variety of players. Challenger banks have grown to levels at which they need to diversify from their initial narrow focus to maintain growth, and are starting to encroach on traditional building society territory; new online-only banks can potentially take on traditional societies in specific segments, armed with their low operating costs and slick engagement models; high-street banks have also been intensifying competition at the "vanilla" end of mortgages and come with the advantages of their scale and funding structures.

Tougher market conditions

Interest rates are expected to persist at historic lows into the medium term, with their ongoing damaging impact on traditional profit-generation strategies, compounding the problem that property is set to be one of the sectors most vulnerable to the uncertainty caused by Brexit and fluctuations in the global economy. Weakened House Price Index growth and higher loss ratios are likely. In addition, regulatory intervention has become increasingly onerous for all retail banking product providers, including building societies, and compliance is ever more costly.

UK Building Societies: Ripe for Reinvention? was written by **Peter Ward** and **Diogo Silva**, Partners, and **Dominique Nguyen-Huy**, a Manager in L.E.K. Consulting's Financial Services practice. Peter, Diogo and Dominique are based in London.

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Evolving customer needs and behaviors

In the contemporary digitally enabled economy, consumers increasingly expect their financial services providers to offer an integrated omnichannel experience. This is a hygiene factor for millennials and following generations, and is also becoming more important for older customers. To date, building societies have generally lagged other sectors in their digital offerings. Furthermore, increasing life expectancy has created a growing senior citizen demographic with specific financial needs, including wealth management for the affluent and dealing with inadequate pension provision for the many less well-off (see Figure 1).

Figure 1
Wealth and income profiles of the retired population

Source: L.E.K. analysis of ONS Asset and Wealth Survey Wave 3 (2010/12, published in 2015)

All these changes need to be incorporated explicitly by building societies to make or keep their offerings fresh and relevant.

Strategic responses: five possible models

Building societies have adopted a number of different business models in response to these challenges. Each model has its own merits and shortcomings, and the strategic choice that each society faces will depend on its level of ambition (e.g., breadth of member needs that they wish to serve) and financial / resource constraints (see Figure 2).

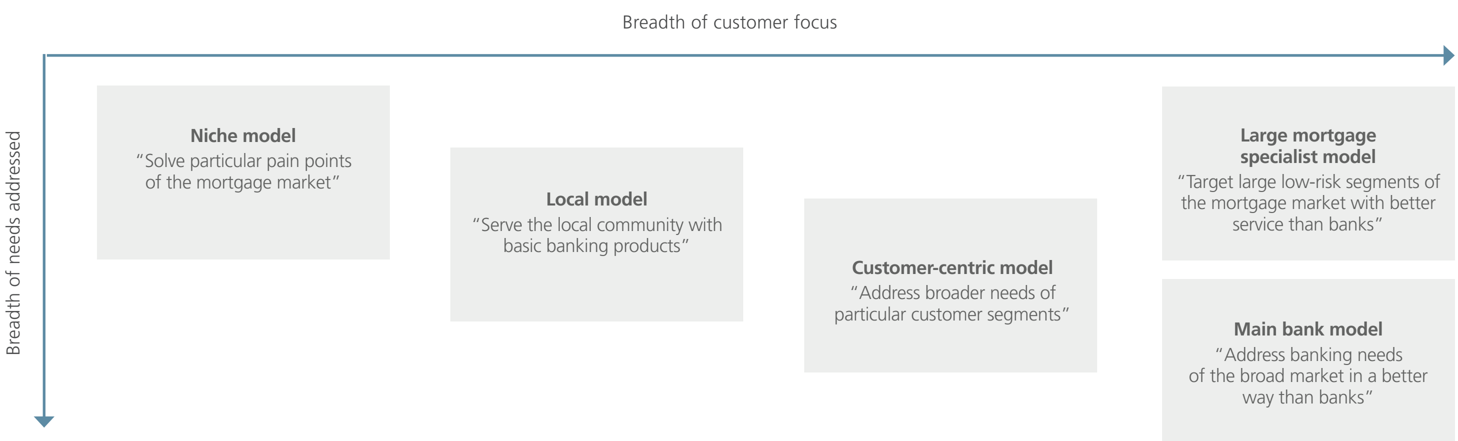
Niche model

This strategy focuses on identifying underserved niches in mortgage and savings products. Competitive advantage can be driven by the ability to identify and address small market segments/niches supported by relevant product innovation, a manual underwriting process, and breadth of distribution network appropriate to the specific opportunities. There are two key shortcomings of this model: First, societies limit themselves to a very narrow subset of customer needs; and second, and importantly, by following this model they also face increasing competition from challenger banks, which have mostly based their strategy on a multiniche approach and may be better funded and resourced.

Local model

This model centers on serving customers in a local geographical area, for whom this approach is appealing as a service attribute. Product offerings are typically broad, with some products perhaps offered via partnerships, and potentially with some products only available locally, or targeted at specific locally relevant business types. However, the product set still needs to be competitive versus larger non-local lenders / banks. This is increasingly difficult given the ability of larger players to serve customers anywhere through the use of digital channels and intermediaries.

Figure 2
Five building society strategies



Source: L.E.K. analysis

Customer-centric model

Particular customer groups, such as specific professions, rather than geographical or product segments are this model's focus. It requires identification and deep understanding of customer needs in the particular groups of focus, supported by development of tailored product propositions to meet these needs, sometimes using both homegrown and partner-distributed products. Cost-effective, often bespoke routes to market are required to make the economics stack up, e.g., partnerships with organizations relevant to the particular professions being targeted. While it is challenging to get this model right, the potential rewards are substantial and it also enables societies to compete sustainably with larger lenders.

Large mortgage specialist model

This model involves disciplined focus on the high-volume, low-risk areas of the mortgage markets, either buy-to-let (BTL) or owner-occupier. A conservative approach and robust underwriting discipline are required to minimize risk and avoid complex operating requirements. Typically origination is intermediated through brokers. Key success factors are a lean operating model to support competitive pricing versus large banks, broad intermediated distribution, and highly disciplined and focused underwriting. Maintaining this discipline may involve choosing not to address attractive short-term opportunities in favor of focusing on sustainable long-term returns.

Main bank model

It is possible to compete head-on with the large retail banks and to achieve differentiation through a strong brand and customer centricity with good customer service, likely enabled through superior systems. This approach is challenging without significant scale. Nationwide has implemented this with success. It would be challenging for other societies to fully replicate this, although it is always possible to consider broadening the product set from the narrow core of mortgages and savings to better serve the needs of members.

A window of opportunity

Creating a winning business model for building societies is undoubtedly challenging. However, the strategies described above offer a menu of options from which to construct a blueprint for success. The strategic building blocks needed to make the change start with a review of goals, target customers, product and service offerings, and the customer engagement process, taking into account a frank assessment of each society's genuine strengths and weaknesses.

In setting a successful course for the next 5 to 10 years and beyond, each society has crucial questions to answer in four key areas:

- Strategic goals: How tightly defined and fit for purpose are the society's strategic goals, especially if they are more traditional and very long-established in nature?
- Target customer base: How open is the society to broadening its customer base beyond historical participation choices, whether defined by geography, demography or retail versus commercial?
- Product / service offering: How open is the society to broadening its product offering beyond historical choices, either in terms of credit risk or product type, or via JVs and / or partnerships?
- Customer engagement model: What are the roles of branches and digital in the customer engagement model? How directly should the society engage with customers, especially in mortgage lending?

In summary, many smaller and mid-sized building societies are now at a watershed. The strategies that have traditionally served them well for many years may no longer be sustainable in an industry where the time-honored way of doing things is being eroded by new competitors and destabilizing macro trends. There are opportunities to build winning propositions; those societies that make it will be those that take a hard look at their strategies and respond quickly and decisively.

About the Authors

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