



BUILDING SOCIETIES ASSOCIATION

ALL PARTY PARLIAMENTARY GROUP FOR BUILDING SOCIETIES AND FINANCIAL MUTUALS: ENQUIRY INTO THE TRUE COSTS OF DEMUTUALISATION

Submission by the Building Societies Association

1. The Building Societies Association is the representative body for all 63 building societies in the United Kingdom. Building societies account for over 18% of all retail deposits in the UK and, with their subsidiaries, approaching 21% of outstanding mortgage balances. They account for almost 37% of cash ISAs. Building societies employ over 45,000 people in the United Kingdom and operate through more than 2,100 branches. They are an important force in UK financial services.

2. The All Party Parliamentary Group has provided a number of questions through its terms of reference. The evidence below answers the various points put forward by the group, but in a slightly different order to that used originally. Points 2 to 6 are covered in the appropriate order below. The answer to question 1 has been used in this evidence as an appropriate concluding point. The only other introductory point to make is that this evidence is based solely on the recent history of the building society sector, where the Association has expertise. No evidence is drawn from, or conclusions made, about demutualisation trends in the life insurance sector.

Is there any evidence to suggest that demutualisation has improved the performance of former societies?

3. It is, of course, difficult to talk about former societies in one group. Performance has varied across the ten institutions that were formerly societies, but which are now part of the plc sector. However, a number of general points can be made –

(i) Loss of independence

4. Seven of the ten building societies that converted are no longer independent institutions.

- **National & Provincial Building Society** disappeared inside Abbey National in 1995

- **Cheltenham & Gloucester Building Society** became part of Lloyds Bank, now Lloyds TSB, in 1995
- **Abbey National**, the first society to demutualise in 1989 steadily lost market share during the 1990s and the following decade, despite purchasing National & Provincial Building Society in 1995. It is now generally accepted that it diversified into the capital markets unwisely, eventually losing substantial sums of money. It agreed to be taken over by Banco Santander in 2004.
- **Woolwich Building Society** converted to plc status in 1997 and was acquired by Barclays Bank in 2000. Woolwich plc no longer exists, Woolwich merely being a brand name of Barclays since 2003.
- A similar process applied to **Birmingham Midshires**, (BM) a building society until it was acquired by Halifax plc in 1999. The new owners of Halifax, HBOS plc, have recently announced that it is closing all of the BM branches – hardly an indicator of improved performance (and contrary to the suggestion in the press release (30 July 1998) announcing the BM acquisition by Halifax that “the board of BM believes that becoming part of Halifax will enable the BM business to improve customer service”.)
- The business of **Bristol & West Building Society** was acquired by Bank of Ireland in 1997. Bank of Ireland sold the savings business of Bristol & West plc to Britannia Building Society in September 2005 in the first remutualisation of any part of a demutualisers’ business. The savings business and associated branches and ATMs of Bristol & West clearly found it difficult to thrive under the plc form of ownership.
- **Halifax plc** which converted in 1997 realised that it was too dependent on its traditional savings and mortgage business to thrive in the plc sector and acquired Bank of Scotland to become HBOS in 2002.
- **Northern Rock plc** (which converted in 1997), **Alliance & Leicester plc** (1997) and **Bradford & Bingley plc** (2000) respectively have remained as independent institutions.

5. Overall, the varying performance of the former societies suggests that it is not possible to come to the conclusion that demutualisation has improved the performance of former societies *per se*; rather in both the demutualised and building society sectors, performance is determined by strategy development, management skill and governance. Nevertheless, there are some clear disadvantages under which plcs labour, which has made it difficult for them to improve their performance since demutualisation. The remainder of this section of the paper covers these.

(ii) Costs of dividends

6. One of the most important disadvantages of demutualisation is that margins need to be wider than would otherwise be the case, in order to pay dividends to shareholders. Analysis of the accounts of plc banks shows that management costs, plus dividends, generally run at about 35% higher than management costs alone. In other words, paying dividends to shareholders adds about 35% to the total cost of running the institution. In order to cover the costs of the dividends, margins between savings rates and mortgage rates need to be higher in a plc than in an equally well performing building society.

7. The lower the margin between the mortgage rate and the savings rate, the less, in effect, the consumer is paying for the mortgage and savings services which the institution provides and they consume. Indeed, the accountants KPMG call the margin “the barometer of consumer value”. As early as September 2003, KPMG – who have both mutual and plc clients – said that the margins exhibited by building societies were “significantly lower than margins of most other mortgage lenders”. Nevertheless, building societies have narrowed their margins further in recent years. According to aggregate statistics from the Financial Services Authority in 2001 societies’ “net interest income”, ie their margin, was equivalent to £1.42 for every one hundred pounds of assets on a building society balance sheet. In 2002, the figure fell to £1.26, in 2003 to £1.24 and in 2004 to £1.13. It is interesting to contrast this with the retention of relatively high margins in the banking sector. In a speech to FSA staff on 29 June 2005, Sir David Arculus, Chairman of the Better Regulation Taskforce said “the spread a retail bank enjoys between the interest rate it pays on deposits and the rate at which it lends has remained at a more or less constant 200 basis points [ie £2.00 per one hundred pounds of assets in the terminology used above] for a number of years.” Sir David felt that this was an indicator of insufficient competition in the banking sector.

8. There is also evidence that in order to generate sufficient cash to pay dividends, plcs take on greater risks, both for themselves and their consumers. For example, in its latest *Financial Risk Outlook* published in January 2005, the Financial Services Authority (which has no particular remit to promote mutuality or any other corporate form) stated that “building society asset quality compares well with the average for the rest of the mortgage market, with arrears levels substantially lower”.

9. Similarly, Simon Tyler of one of the largest mortgage brokers in the country, Chase De Vere (which distributes mortgage products for both banks and building societies), was quoted in *The Times* on 8 May 2004 saying that “building societies tend to be more patient with borrowers in financial difficulty, whereas banks may repossess relatively quickly because they have shareholders to satisfy.”

(iii) Branch closures

10. The next issue suggesting that demutualisation has led to deteriorating performance of former societies comes in the statistics on branch closures.

Converted building societies closed about a quarter of all their branches between 1995 (when many societies announced, or began to contemplate, conversion) and 2000 (the final year in which there were any building society conversions in the UK). In detail, the converted institutions closed 24% of their branches; in contrast, the building societies closed 2.4% of theirs – precisely one tenth the rate of closure. Other, longstanding, banks closed 17% of their branches during this period.

11. In recent years the rate of branch closures slowed has down. Nevertheless, the banks are still closing branches more rapidly than building societies. (In passing, it is worth noting that it is now not possible to obtain statistics for all of the former building societies' branch networks; some have been fully integrated into their parent banks' network and it is no longer possible to chart the progress of the demutualised institutions so effectively.)

(iv) Change of Culture

12. A further area that suggests that demutualisation has not improved the performance of former societies comes from a revealing couple of quotations from the Woolwich Building Society and Woolwich plc. In the transfer document which the Woolwich Building Society – like others – was required to circulate to its members to give them the information they needed to decide whether to vote in favour or against demutualisation, the Woolwich stated the following -

“We believe very strongly that retaining the Woolwich’s culture and values is important for ensuring that the Woolwich’s high standards of customer service are maintained and for safeguarding the future of its management and employees.”

This document was published in January 1997.

13. In the *Financial Times* of 19 February 1998, the following appeared -

“Commenting on the departure of 25% of the group’s senior managers during and since the conversion process, John Stewart, Group Chief Executive, said –

“Culture has been the biggest change at the Woolwich over the last year to 18 months. A building society culture is wonderful in terms of customer care, but it isn’t particularly good at identifying where the value is in the business. We need a different type of person in the future.””

14. The quote is interesting on two levels. First of all, the departure of 25% of the group’s senior managers suggests that the Woolwich was not successful in achieving the objective set in its transfer document on “safeguarding the future of its management”. Secondly, the change in culture also suggests that the objective in the transfer document of “retaining the Woolwich’s culture and values” was also not achieved. Put very bluntly, the former Chief Executive of Woolwich plc (who is now Chief Executive of National Australia Bank) was saying that building societies

were good in terms of looking after customers, but this was not the type of staff that a bank needed. Rather, a bank needs staff who are able to exploit customers in order to make a profit.

15. This point was put more succinctly by the distinguished commentator, John Plender, writing in *The Financial Times* on 20 October 2003. He said “the arrival of [the concept of] shareholder value bled the decency from the culture of banking”. Another commentator, again with both mutual and plc clients, has put the same point thus: “Becoming a listed company adds to the pressure to make profits, which can definitely have a detrimental impact on service because banks have to cut costs while continuing to attract customers with competitive products. The result is often that they reduce the number of staff, which has a knock-on effect on the service their customers receive.” (Colin Bell, Purely Mortgages, a mortgage broker, quoted in *The Sunday Times* 1 May 2005.)

(v) Direct Costs of Demutualisation

16. The final area of this section covers an important topic different in nature to the above, but nevertheless still relevant. The direct costs of demutualisation are significant. Professional investment banking, accounting, public relations and legal advice do not come cheap. The costs of printing and posting transfer documents to many millions of members were also a factor. Overall the costs estimated to be incurred as a result of the demutualisations in the various transfer documents posted to members of building societies amounted to £549 million. (Full details are given in Appendix 1.) This figure does not cover the costs of those institutions acquiring mutuals (eg Abbey National’s costs in acquiring National & Provincial), nor does it include the costs of the various life insurance demutualisations. It also ignores the effects of inflation; the last building society demutualisation occurred in 2000 and the costs of professional advice have probably increased significantly since then. The Association is doing further work in this area, but it would not be surprising if the full costs of all demutualisations in current day prices amounted to well over £1 billion.

What effect has demutualisation had on the remaining mutual sector?

17. It is important to look at the background of demutualisation in answering this question. There are four key factors -

- (a) The general intensification of competition in the early 1980s. The building society mortgage monopoly which had effectively existed from the 1930s until 1979 broke down in the early 1980s as the banks entered the mortgage market. Simultaneously, the BSA’s recommended rate system under which every building society agreed to charge and offer the same mortgage and savings rates respectively, broke down and a fully competitive market developed.
- (b) Privatisations gave the example. The Conservative Government had developed a policy of extending share ownership through privatisation of

nationalised industries. “Privatisation” of building societies (which were already in the private sector) was a natural extension in some people’s minds.

- (c) The philosophical mood change in the 1980s from collective forms of ownership (eg mutual financial institutions and trade unions) to individual forms of ownership (for example plc and individual negotiation of contracts in the labour market) was consistent with the idea of demutualisation. Mutual building societies are owned collectively by their members. Plcs are owned individually by their shareholders. In plcs it is possible to buy votes on the stock market by purchasing shares, thus enhancing the role of particular individual shareholders dependent on their economic power. The one member, one vote ethos of mutuals, in which everyone was equal irrespective of their economic power, was inconsistent with the mood of the 1980s.
- (d) Finally, the Building Societies Act 1986, heavily influenced not only by the Building Societies Association, but also by those institutions which felt they would benefit from significant demutualisations, provided a mechanism for building society demutualisation.

18. Given this background, it is now possible to answer the question of the effect of demutualisation and on the remaining mutual sector. The effects can be divided into two. The early defensive measures taken by the remaining building societies to ensure they were not swept along by the demutualisation mania and the more positive measures which societies took later to promote the concept of mutuality.

(i) Early defensive measures

19. The payment of significant windfalls (see below) by the converting building societies meant that membership of a building society was *perceived* as offering “free money”. As a result, the remaining societies experienced vast numbers of account openings. At one stage in 1997, Nationwide Building Society was opening 125,000 new accounts per week – the equivalent to more than five million per year. Other societies experienced similar, proportionate, onrushes of speculative account openers. This was not sustainable. A number of societies increased the minimum balances required for opening accounts; others insisted on a “locals – only” policy, both of which were clearly not in the interests of the generality of consumers. An appropriate answer to the issue did not arise until November 1997 when Nationwide introduced a charitable assignment arrangement which meant that those opening new mortgage or savings accounts agreed, as part of the terms and conditions of opening the account, to assign any windfall which came their way in the future to charity. It was essential to break the link between opening an account and a windfall to enable societies to offer the full range of services to consumers, especially those consumers with relatively small amounts to invest.

(ii) Longer term promotion of mutuality

20. Once these early defensive measures had had the desired affect of reducing the influx of new account holders who wished to join the society only to destroy it and take a short term benefit from the wreckage, building societies were able to address wider issues. By the late 1990s, many building societies were deliberately reducing their profitability and the margins under which they operated in order to return to their members the “dividends” that would have gone to shareholders had they converted. Over the last few years building societies have

- (a) Redefined the concept of member value. As banks have taken on board the concept of maximising *shareholder* value, building societies have done the same in respect of *member* (ie customer) value. For societies this means squeezing margins; optimising, not maximising profits and maintaining branches, for example.
- (b) Re-engaged with their members and improved corporate governance. This has meant increasing voting turn-outs at AGMs; putting AGM webcasts on the internet; making annual reports, summary financial statements, and AGM voting materials easier to understand; organising AGM votes on directors’ remuneration; finding innovative ways of learning about members’ views, through member panels, a Member Council, on-line conversations between members and chief executives, and member road shows, for example; investing more in member newsletters; and advertising for directors.
- (c) Offered market leading products. Using the concept of member value, building societies have typically been at the head of the performance tables for the cheapest mortgages over long-term periods; the tables for TESSAs and ISAs have shown the same results.
- (d) Influenced the wider market to the benefit of all consumers. For example, no building societies charge their customer (or any other users) for access to their ATMs. Societies have been at the forefront of the campaign to maintain as large as possible an estate of free-to-use ATMs at other institutions. Similarly, building societies lead the campaign to preserve the current £3,000 limit on contributions to cash ISAs, persuading the government to reverse its proposal to reduce the figure to £1,000.

21. Over the last five years building societies have rediscovered their self-confidence, redefined the philosophical background to their existence and reconnected with their members. To a limited extent this has been due to the pressures created by the trend towards demutualisation of five to ten years ago.

How has demutualisation affected consumer choice?

22. As noted earlier demutualisation has resulted in the disappearance of a large number of organisations. Accordingly, consumers are no longer free to choose to do business with those organisations that have disappeared or have merely become brand names fronting the savings and mortgage activities of other institutions. It is, moreover, now more difficult (although nowhere near impossible) for consumers to do business with organisations that do not have, as their principal objective, the maximisation of profit, rather than customer value. It is also notable that building societies tend to fill niches ignored by others in the mortgage market. Mortgages that would be attractive to those concerned about the ecological impacts of housing are available only from two building societies, for example. Moreover, local and regional building societies typically have more personal credit assessment systems than large banks, more detailed knowledge of local housing markets, and a greater capacity to lend outside normal lending criteria. This means that, for some customers, mutuals add an essential element of choice that would be lost if the mortgage market were populated only by plcs.

23. Having said this, it would be absurd to assert that the British retail financial services market suffers from a *general* lack of choice. That market has abundant choice with a wide range of new entrants, a wide range of products and, over the last ten years, a growing range of access mechanisms – the internet being the obvious example of a growth area.

24. Overall, the Association believes that consumers in the retail financial services market have plenty of choice, but that demutualisation has restricted that choice below the level that would otherwise have been available.

Did the level of windfalls reflect the economic value of members' interests?

25. Arguably, the market mechanism worked and the economic value of members' *collective* interests were properly reflected when, for example, Halifax Building Society transferred its engagements to Halifax plc and that organisation was floated on the stock market. The market assessed the value of the future dividend streams that Halifax plc was going to produce and investors purchased shares in Halifax plc accordingly. The shares were sold by the former members of the building society and in a collective sense the economic value, in so far as this was accurately established by the market, was returned to members. However, this hides a crucial point: in virtually no cases was the economic value of individual member's interests returned to them. Rather, in very many cases, members were compensated by shares that were far in excess of the economic value of the business which they did with the former building society, and this gave members a perverse incentive to vote in favour of demutualisation. In contrast, in some cases, especially in the case of the purchase of some of the smaller societies such as Birmingham Midshires and Bristol & West by plcs, the value of the mortgage borrowers' interests were not properly reflected in the windfall that they received. The increased mortgage payments that these borrowers have made in recent years far exceeded the value of the windfall they received on demutualisation.

26. It is worth looking in more detail at this. The average windfall payable to an investor or borrower in the Halifax Building Society when it became Halifax plc was around £2,200. There was only a shallow relationship between the size of balance in an investor's savings account and the number of shares received. Accordingly, small investors received windfalls far in excess of the economic value of their interests. Some large mortgage borrowers received a windfall that was below the economic value of their interest. In other societies – Alliance & Leicester for example – there was no correlation at all between the size of the account relationship with the society and the number of shares – and windfall – received by the investor. Every investor and borrower received exactly the same number of shares. This policy was pursued by the converting societies because every member had only one vote on the resolution to convert irrespective of the size of the relationship with the society. It would have not have been possible to have paid a windfall consistent with the economic value of member's individual interests because, with most investors having only small investment accounts, the windfalls for the majority of investors would have been fairly small and this would have endangered the conversion process. Consistent with the values that the new mortgage banks would have to exhibit on the stock market, it was necessary for those proposing conversion to, in effect, purchase the votes.

27. There are also wider economic considerations that were not taken account of in the conversion process. Many observers termed the payment of windfalls to the current members as “intergenerational robbery”. In effect, the capital that had been accumulated by previous generations of members of a converting society was distributed to the current members rather than, in effect, kept in trust for the benefit of future members. Current members had been able to obtain the cheaper mortgages and better savings deals inheriting mutuality (because of the non-payment of dividends) and were then able to sell their interest in this arrangement denying future generations the benefits. Many would argue that this was fundamentally unfair.

28. One of the features of building societies is that they draw their supplies from local suppliers, employ local staff and draw their management from local communities. Plcs tend to be far more orientated towards the City of London. The loss of local decision-making, local suppliers and local jobs were not factored in to the decision-making process. Indeed, the “externalities”, as economists term them, of demutualisation have received little attention, and is an issue the BSA will be examining in 2006.

Have consumers benefited from demutualisation?

29. In the very short term, those consumers who were members of building societies entitled to a windfall, benefited from demutualisation. In the longer term, however, there have been a number of losers from demutualisation -

- (a) Those individuals that used the branches previously operated by the demutualisers.

- (b) Those paying higher mortgage rates than would have otherwise been the case had the demutualisers not had to service the dividend expectations of City investors.
- (c) The diminished savings returns enjoyed by some investors as a result, again, of a requirement to service dividend payments.
- (d) Those who have suffered from the declining customer service epitomised by the quotation from the Woolwich referred to in paragraphs 12-13 above.
- (e) More generally, future generations of borrowers and savers.

30. In general it is difficult to see how a shift from organisations that are accountable to their member/customers, to organisations that are accountable to shareholders, can benefit customers. The appropriate answer to the question is accordingly “no”.

31. It is now possible to move to the first question posed by the Group, which marks the conclusion of the Association’s evidence.

Are former mutuals better than remaining mutuals at providing financial services?

32. Not surprisingly the Association’s overall conclusion is another “no”. Building societies consistently top the best buy tables, the league tables of performance prepared by groups such as Moneyfacts, the financial analysis tables produced by accountants such as KPMG and the tables on consumer satisfaction prepared privately for banks and building societies based on market research of their customers. Demutualised organisations must necessarily take their eye off the consumer so as to fill their legal obligation to be accountable to shareholders. It is inevitable that, despite protestations that companies can pay dividends to shareholders only if they meet customer needs, this legal accountability affects the performance of demutualised organisations.

33. The chief executives and executive directors of mutuals know that they face re-election by customers/members every three years. Virtually all building societies now have a vote on directors’ (including chief executives’) pay every year. This concentration of consumer power is in addition to the usual right of consumers to move their business elsewhere if they are dissatisfied with the service they receive from an institution. If the chief executive and board of Barclays Bank, for example, faced triennial re-election by depositors, it is debatable whether that bank would have sought to close 171 branches in one day, as was the case early this decade, simultaneously propose the introduction of ATM charges and incorporate a pay scheme for senior staff that, dependent on share price movement, could have seen their pay grow rapidly. Indeed, there is a powerful case for taking some of the elements of the mutual model outside their normal context and inserting them into the plc structure. Which? (formerly known as the Consumers’ Association) is, for example, proposing a series of initiatives designed to promote the interests of consumers within the thinking of financial firms, including, for example, consumer

representation on boards. It is clear that such initiatives would probably not even need to be discussed in a predominantly mutually-owned financial services system.

34. The shift to shareholder focus and away from consumer focus, which lies at the heart of the demutualisation process suffered by the UK over the last few years, makes it difficult for the former mutuals to be better than the remaining mutuals at providing customer-friendly financial services.

Estimated Costs of Building Society Demutualisations

Demutualised Institution	Estimated Cost of Demutualisation (£m)
Abbey National	80
Alliance and Leicester	58
Birmingham Midshires	42
Bradford and Bingley	68
Cheltenham and Gloucester	20
Bristol and West	24
Halifax	153
National and Provincial	23
Northern Rock	32
Woolwich	49
TOTAL	549

Note: The figures are taken from each institution's Transfer Document sent to members to enable them to make an informed decision before voting on the demutualisation proposal.