

Sharing services for cost and benefit

The Saffron House View

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Market conditions – is there compulsion?

Viability – can it work?

Benefits – what are they?

Reason not to – lots!

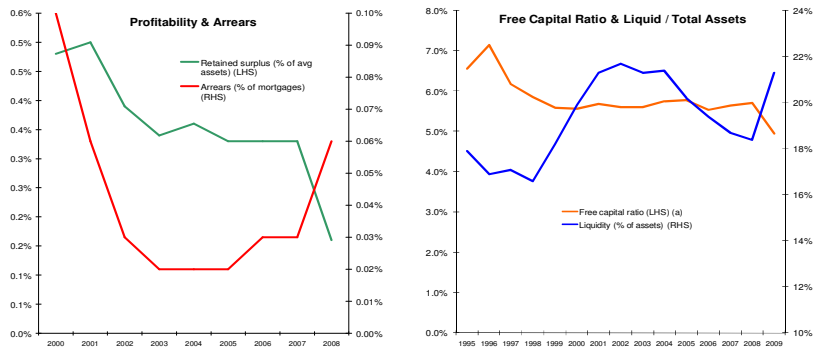
Summary

Go out – get married – get adopted?

Areas to cover:



- Sector profitability has declined continuously since 2001 – driven by pre-crisis competition from banks, high cost bases and more recently, the FSCS levy and rising provisions as margins have declined significantly due to low base rate.
- The regulatory framework will require higher capital & liquidity cushions – and hence larger organisations with higher levels of profitability to absorb cyclical fluctuations.

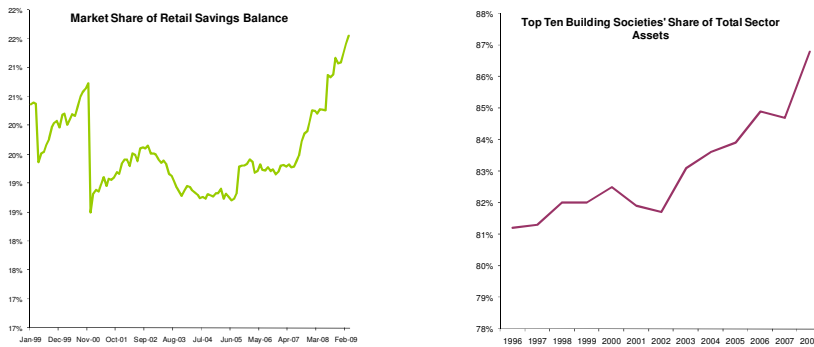


Source: BSA

Market conditions:



- Building societies increased market share in retail funding to end Q1 2009 as bank insolvencies and reputational damage weakened the main competitor sector, but at a price – recently 60% of the best-buys were from building societies vs only 9% from high-street banks.
- However, it is also clear that the main beneficiaries of additional savings inflows have been the largest societies – the top 10 now control 93% of total sector assets.

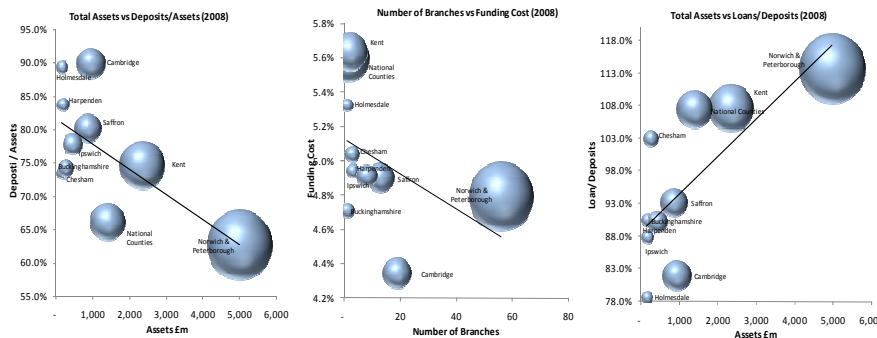


Source: BSA & Moneyfacts

Market conditions:



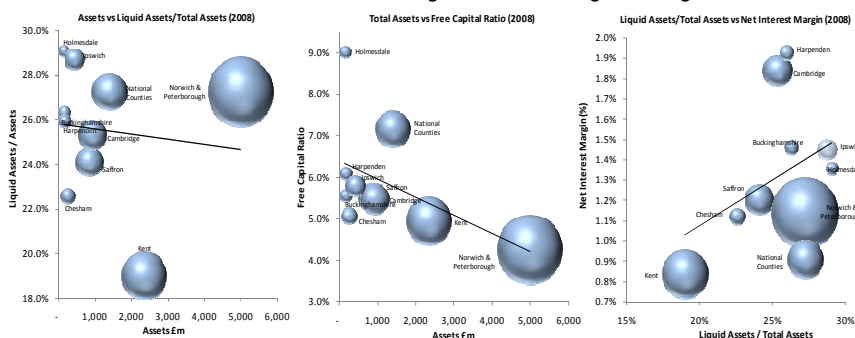
- Larger societies appear to have better access to wholesale funding which in turn enables growth.
- Societies with larger branch networks have enjoyed lower funding costs – demonstrating the efficiency of scale of this distribution channel.
- As a result, larger societies can lend more relative to their deposit base than smaller ones, reinforcing the benefits of scale over time.



Market conditions: funding costs



- While the financial crisis has lead most societies to increase their liquidity, smaller ones tend to hold more (a).
- Smaller building societies also have to hold higher levels of capital, insuring themselves against higher levels of depositor / counterparty uncertainty.
- The relationship between size and capital/liquidity levels reinforces the reasons against 'smallness' as surplus cash can less easily be used to fund balance sheet growth despite sometimes attractive margins
- Smaller societies are less able to afford margin reductions to generate growth.

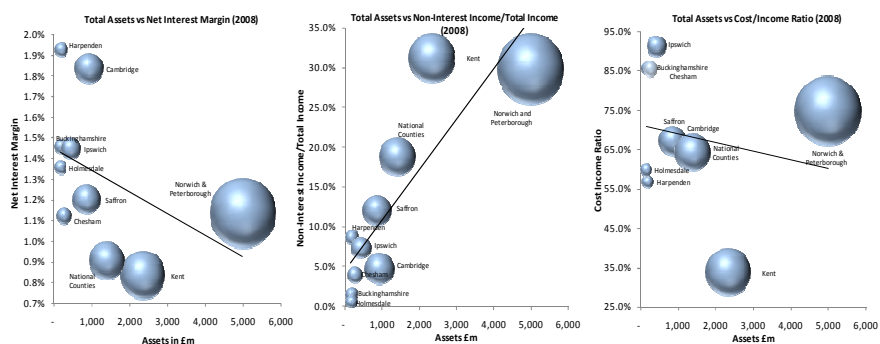


(a) Kent's lower ratio reflects the redemption of £35m sub-debt at a significant discount in May 2008

Market conditions: ability to grow



- Larger building societies can therefore afford to have lower net interest margins than smaller ones – and they can offset them with more efficient cost structures and higher levels of non-interest income.
- There are clearly some economies of scale in back-office management, customer service and origination activities



Market conditions: margin/income



The big issues for societies...

- Significant reduction in margins with BBR at 0.5%
- Inability to raise core tier 1 capital
- Scarcity/cost of wholesale funding
- Regulatory pressure (lots of it)
- Sub-scale: only 15 of 51 societies have assets > £1bn
- High operating costs relative to balance sheet size
- Intense competition from HMT supported institutions and others
- High FSCS contributions erode capital further and in some cases losses eroding capital further

Building society mergers can mitigate these key challenges



Market conditions:

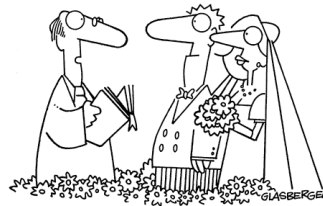


- It is my view that if shared services is going to radically transform a society's cost base and therefore long term viability; that the action must be as radical as the transformation required.
- There are lots of examples of small pilots that demonstrate sharing: a bit of stationary buying, pooled insurance or training initiatives. However whilst all these are positive, their financial benefits are minimal.
- There is no point one society after a bit of shared procurement trying to work with another who wants radical transformation – it won't work!



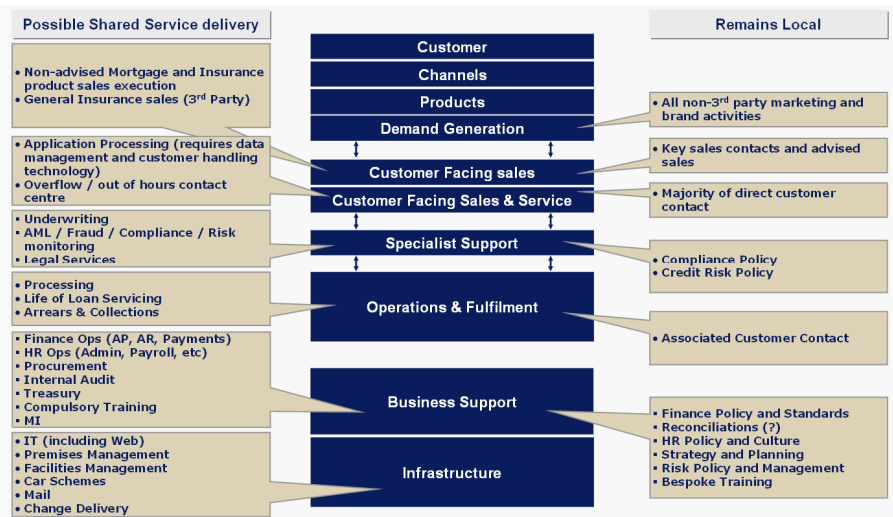
It is easy to hold hands – marriage takes a bit more work....

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"Do you, Jason, take Karyn to have and to hold, to E-mail and fax, to page and beep, until death do you part?"

Viability: go out or get married?



Viability: what does marriage look like?



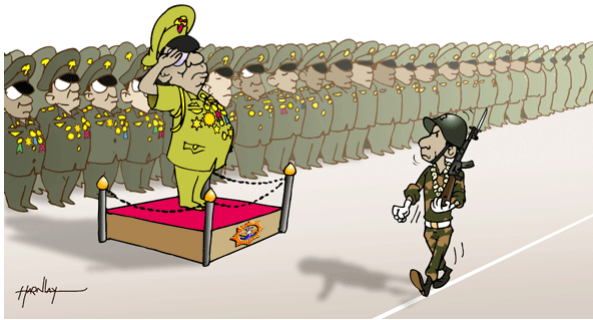
<p>Cost Savings</p>	<p>Initial, experience-based analysis suggested savings of between 20 and 40% of process cost for in scope areas. Review against the businesses suggests this figure is if anything conservative given the lack of processing scale</p>
<p>Regulatory control</p>	<p>A significant benefit is the adherence to regulatory control which can be embedded in the culture, process design and documentation for the new entity</p>
<p>Process Enhancements</p>	<p>Service would be defined and managed through Service Level Agreements between the Societies and the new entity. As well as enabling better customer service provision through scale efficiency (e.g. out of hours), by learning from all societies and focusing on continuous improvement, process effectiveness is likely to be enhanced in both customer and non-customer facing areas</p>
<p>Revenue Opportunities</p>	<p>There are two significant sources for revenue enhancement – first, within the Societies, by freeing up sales capacity and supporting it with more efficient processing capacity; second, by providing services to other lenders</p>

Viability: potential benefits...




The mortgage processing example:

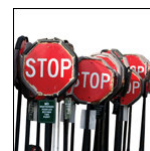
4 societies between them had enough processing resource to handle over £2Billion of new mortgage lending annually, their collective plan was circa one quarter of that!



Viability:



- Risks, obvious but numerous: (reputation, capital, regulatory, people, member, not actually realising the benefits, eye off BAU etc.)
- Complexity of structure: (a new mutual, parent shareholders, VAT, SLA's ownership, governance etc.)
- Parochialism/protectionism: (will it be as good, will it put us at risk of merger later, does it mean redundancies etc.)
- Loss of control: (will I really have a say, what about favouritism, will it be as flexible etc.)
- Culture: (can the organisations really work together, are the boards aligned in their desire for efficiency and radical change, pace etc.)
- Oh and IT is difficult: (or is this just an excuse?)

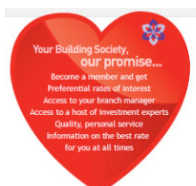
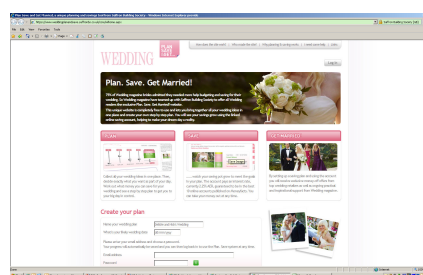


Reasons why not:



Any good marriage takes:

- Careful planning
- The right partner
- Common goals
- An acceptance that things are not always perfect
- A leap of faith
- Commitment
- Compromise
- Love



Well I love this sector and I love Saffron BS and to make sure it can do another 160 happy years – with the right partner/s I'd say "I do"

Summary



Thank you for listening...

<http://www.saffronbs.co.uk/blog/>

