

ALL-PARTY PARLIAMENTARY GROUP ON  
BUILDING SOCIETIES AND FINANCIAL MUTUALS

MINUTES OF PROCEEDINGS

at a

PARLIAMENTARY HEARING

held in

Committee Room 21

on

Tuesday, 26 October 2004

Before:

Mr Adrian Bailey (Chairman)  
Sir John Butterfill  
Dr Vincent Cable  
Mr David Drew  
Mr Mark Lazarowicz  
Mr Andrew Love  
Mr Peter Pike  
David Taylor  
Joan Walley

(From the Shorthand Notes of:  
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**Witness:** MR ADRIAN COLES, Building Societies Association, examined.

**CHAIRMAN:** Welcome. You are an anachronism according to a lot of people. How would you respond to that?

**MR COLES:** I think the plc form and the building society form were both formed in the 19th century. They are both 150 years old. They both originate as a way of organising economic activity. Neither is out of date. There are very strong mutual institutions, very strong plcs; I do not think any particular corporate form is an anachronism but you may be interested in some statistics that I looked at recently. The number of plcs quoted on the London Stock Exchange, both the main and the Alternative Investment Market, in the last six years has gone down 40 per cent; the number of building societies has gone down 11 per cent, so perhaps it is the plc sector that is more close to being an anachronism than building societies.

**CHAIRMAN:** What can you provide for communities that banks cannot?

**MR COLES:** Local knowledge, local understanding, local management, local decision-taking. Those are the key factors that a building society provides. If you try and get those factors out of an organisation that is accountable to the international capital markets, then you will face huge difficulties. If you want an organisation that understands customers, is close to its customers, is managed by people that do not work and live in the City of London, then you look at a local institution such as a building society or many of the local friendly societies.

**CHAIRMAN:** You will be familiar with the Ernst & Young report. In there, one of the comments that was made is that some of the larger mutuals use the mutuality brand as a marketing tool but do not really have a strategy for delivering benefits of mutuality to members. What would your comments on that be?

**MR COLES:** If you look at the main benefit of mutuality it is the non payment of dividends to shareholders - because there are no external shareholders - and if you did have external shareholders it adds about 35 per cent to your costs. If you look at management expenses with dividends that is about 35 per cent higher than management expenses on their own, and all leading building societies and most of the smaller ones have taken advantage of that mutuality dividend either to operate on narrower margins between mortgage rates and savings rates, or to keep branches open, or to enhance their service in some other way.

It is interesting, I do not believe many building societies have tried to use mutuality as a marketing tool; they probably should have done it more. If you go out and ask all of the investors and borrowers "What does mutuality mean?" you will not find many people understanding it, so probably building societies should have marketed their mutuality more than they have done. I think they have delivered the benefits of mutuality to their customers without marketing it as much as they could have done.

SIR JOHN BUTTERFILL: On the other hand Ernst & Young have said that building societies, a lot of them, are mutuals in general but do not seem very sure themselves about the benefits of mutuality. When we look back at the roots of the building society movement and the way it was rooted in communities and had a lot of value and did an awful lot in the communities and the way it was founded we do not see that as much any more. Do you think building societies and mutuals in general should be doing more to provide non-financial benefits for their members, and make it clear that there are real benefits in mutual organisations?

MR COLES: You can always do more but I would not agree with you when you say that building societies are not as active in their local communities as they were. If you go to many societies – and I pick out just a few - Darlington, Newbury, Marsden - and look at the contribution they make to their local communities in terms of sponsoring the boys' and the girls' football leagues and the agricultural shows, sending around their charity buses to every single charitable event, supporting the local theatres, much of it unannounced, much because they really want to communicate with the community rather than because they want to make a big show about being there and specifically getting new business. There is a huge amount going on; there is a deep commitment to local communities from building societies that probably was not even there twenty years ago.

CHAIRMAN: Picking up on that, next Monday I am to open a school playground which is being sponsored by Barclays. So what? Barclays, the propriety company, capitalist villains also do that! Is there anything else a building society could do to distinguish themselves to the mythical, or hypothetical, man in the street?

MR COLES: Clearly plcs want to get to the kids as young as they possibly can. You would expect banks not to miss a marketing trick. But the point is what is the motivation? Is it to get more customers or support a local community, and if we only had Barclays and one or two other large banks based in the City of London available would they still be doing that? One of the banks' catch phrases is "It's the world's local bank" - that is not Barclays but another, and it is probably because of the pressure from local institutions that being local is attractive that has made them act in that way.

MR LAZAROWICZ: That is not an argument for building societies per se. It might be an argument for having localised or regional banks, but it is not a particularly unique theme to building societies. You have to indicate what is unique.

MR COLES: What is unique about building societies is the fact they exist for their customers, not their shareholders, who they are responsible for, accountable to, and if they get things wrong they can kick them out. That is building societies - responsible, accountable, and able to be kicked out by customers.

If you look at the banks, do you think Barclays would have succeeded in closing 170 branches, on the same day as it announced the introduction of ATM charges, on the same day as its chief executive announced that if the share price went in the right direction it could earn him £30 million? Could Barclays have pushed that through if they were

accountable to their customers? Would the Barclays' chief executive be re-elected to the board if he faced customer pressure rather than shareholder pressure? That is what is different about a building society.

MR DREW: Looking at the whole area of demutualisation, you heard the slight argument between David Taylor and our previous witness, and I have always been of the mind that insider trading has had a substantial influence on whether this has been driven forward. What is your perspective on the reasons why we had this mania of demutualisation during the 1990s?

MR COLES: It was led by one institution and surprisingly not Abbey National. They demutualised in 1989 and there was not another demutualisation until 1995. There was a six year gap and then it was Cheltenham & Gloucester, and what Cheltenham & Gloucester showed was that if you voted in favor of demutualisation you got £2,000 for nothing and that put huge pressure on the directors of many institutions to deliver £2,000 for nothing to their members; it took a lot of courage by the large building societies that did not demutualise to stand up against that pressure and not follow that trend. It was a fad, a fashion, it seemed to be the thing to do, it was happening in other countries as well as the United Kingdom, and a lot of boards of mutual institutions were not able to withstand that fashionable trend.

MR DREW: If with the benefit of hindsight we were to have our time again and you were brought in, having seen what happened, and were asked how you would fight those demutualisations, what would you now advise?

MR COLES: I think legislation probably should have been different. What was wrong in the mid-1990s was that you could join a building society one day and obtain a vote the next day on which you would vote yourself £2,000. Nobody looked at the demutualisation question when they were members of a building society with a view to saying "Why is plc form better than the mutual form?" What they were looking at is "Would I like £2,000 apparently for nothing?"

There is much evidence now, but there was very little evidence at the time, that if you voted for demutualisation you got higher mortgage rates and lower savings rates, but at the time people could just join a building society, vote for demutualisation and get a windfall, and that was a fault in the legislation that, if we had our time over again, we should correct.

MR DREW: Now, from all the evidence societies acquit themselves well when compared with plcs, and then they appear at the top of the best buy tables. Why is this so? Is it that building societies now have got their act together, is that the reason, or is there a genuine disadvantage that plcs do have the best mutuals, not least because they have to replenish the confidence of shareholders?

MR COLES: As I said earlier, you increase your management cost by 35 per cent when you pay dividends. The average margin between mortgage and savings rates in the

plcs, the converted building societies which are now banks, is 1.5 per cent. The average margin between mortgage and savings rates in mutual building societies is about 0.9 per cent, so there is a 0.6 per cent advantage overall. That does not stop banks introducing products that get to the top of performance tables briefly. Building societies, even with that advantage, cannot offer the very best product in every single market segment, but overall building societies offer the better deal because of that dividend advantage.

MR DREW: You did, in effect, blame legislation for the vulnerability of societies in the 90s, but do you not think that really is passing the buck? People were prepared to exploit the laxness in legislation because building societies had not communicated effectively with them the advantages that being a member of a building society offered them as members.

MR COLES: I think there is some truth in that. If you look at the performance indicators that many building societies used in the 1980s and early 1990s you will see that many of them were plc performance indicators. I think building societies were going along the wrong route in the late 80s at the height of the Thatcher boom where profitability ratios and cost income ratios and all the other banking indicators were used to indicate building society performance, and I think that was wrong. It was only after the mid-1990s demutualisations that building societies again found their real roots and decided they really should be accountable to the customer and not to the profit ratio.

MR DREW: So we can thank the carpetbaggers for the rediscovery of mutual roots?

MR COLES: As in all organisations a gentle kick up the backside is hugely beneficial from time to time.

MR LAZAROWICZ: It has been suggested that in many cases the financial motivation, or the potential financial benefit for directors, has been the key motivation for demutualisations in some cases. What would you say in response to that suggestion?

MR COLES: Difficult. I have never heard a director of a building society about to demutualise say that the reason they are demutualising was to enable the directors to earn more money! I am not a psychologist so it is difficult for me to tell precisely what was in their mind at their time! One can only observe that salaries rose extremely rapidly after demutualisation and share option schemes were a very important part of the salary packages.

MR LAZAROWICZ: Are you aware of any cases where there has not been such a windfall?

MR COLES: I am not, no.

CHAIRMAN: Do you think it is the greed of the directors or the interests of members that is the driving force behind demutualisation?

MR COLES: I would agree with Steve Huxham that it is certainly the directors who have led the process of demutualisation. I agree also with Steve that in the case of Bradford and Bingley, had that board been very against demutualisation it could have prevented the demutualisation of that organisation. There are no examples that I can think of where the members have led the demutualisation process and, if they had had it explained to them properly at the time of demutualisation that in exchange for their windfall they would get higher mortgage rates and lower savings rates, you would have probably found far less support for it, but the trouble is that the presentations that were made by building society boards at the time of demutualisation were very one-sided.

MR LOVE: This is rather an appropriate time for me to come in because since you were agreeing with Steve I will put the question that has been hanging in the air since he finished his contribution. He suggested three changes that building societies might want to look at: enfranchisement, making everyone a member; communication, having a member's voice on the board of directors; and governance, clearly a criticism of building society governance. I am sure he said that when he was at your conference so you have had good warning of it!

How do you respond?

MR COLES: On the governance issue, there is lots happening in building societies. The BSA has adapted the combined code that emerged from the Higgs report. We sent it out to our members with a recommendation they follow it. It clearly needed adapting because there is a lot of recommendations in the combined code about share options and other issues that can only possibly affect plcs, but nevertheless we have sent that out now and we expect large numbers of building societies to follow the combined code, and to declare they are doing it either this year or the year after.

Many more building societies are now having votes on directors' pay – societies accounting for over 90 per cent of all society members last year. They are distributing much more information about directors' pay as well; so corporate governance of societies is increasing and improving quite significantly. There are lots of initiatives as well to get the members more involved in the running of a society.

As far as customers of subsidiaries becoming a member of the society, that is quite difficult. If there is a mutual organisation and you set up a subsidiary, the existing members of the mutual are in effect investing in a subsidiary. If you make the customers of the subsidiary members as well, what that means is the existing members have given away their investment to the new customers of the organisation, so that is quite difficult.

I am afraid I have forgotten the middle point that Steve made.

MR LOVE: It was about having a member's voice. There was a suggestion that there may be tame directors on boards of building societies, and that what you need is a genuine authentic voice of the grass roots.

MR COLES: If you look at the Nationwide, for example, they have had a contested AGM every year for 22 years, since 1982, so there is plenty of opportunity in the largest building society for the members to be involved. The second largest, the Britannia, has established a members' council which has 12 ordinary members not connected with the board in any way, chaired by a non executive director of the Britannia; they get presentations on the corporate and marketing plans for various initiatives that the building society is taking forward, and they can comment on it and influence it. Lots of societies have members' meetings where they invite the members round for a glass of wine and a sandwich and an hour's conversation about the way the building society is developing, so I think societies have improved a lot over the last ten years and will continue to do that.

MR LOVE: Could I go back to the Ernst & Young report which came out some time ago, which focused on this combination of consolidation in the financial services market place added to the very severe competition that now exists within the market place and they said that the smaller regional societies would be placed under enormous pressure in their markets and that quite a lot of them might have to come together, and we have seen some of that amalgamation activity.

Do you accept those results of Ernst & Young and do you think it is going to mean a smaller, more focused building society movement in the future?

MR COLES: We will clearly continue to see mergers amongst building societies. To say there would never be another merger of any building society would be ridiculous. But the process of consolidation is being pretty slow. Those societies that have survived the recession of the early 1990s, the introduction of the Financial Services and Markets Act and are now surviving the introduction of mortgage regulations are pretty tough and well placed to continue in place, so there is a huge amount of resilience in the building society sector. My view is that the rate of consolidation will be relatively slow and certainly much slower than it has been in the business that Ernst & Young comes from.

MR LOVE: Can I shift you completely? There has been a lot of criticism in the past about the legislative framework in which building societies operate and how that might have tended towards allowing demutualisation, but there has also been some criticism about the regulation of financial services authorities and, prior to that, the registering. Are you concerned at regulation and do you think there has been a force for demutualisation in the past?

MR COLES: I do not think it has been a force for demutualisation. We are immensely concerned at regulation. Last time we did a survey on the number of consultation papers from various organisations that we were responding to, in April this year, it came to about 50 papers that we were looking at from the FSA, from the

Treasury, the Inland Revenue, from Europe, from the Banking Code Standards Board and the DTI, and that is ignoring health and safety, environment and other non-financial issues. There is a huge regulatory burden which will get worse this weekend with mortgage regulation coming in on 31 October. It would be appalling if the only institutions that could survive in the modern markets were those with big compliance departments.

We are confident that building societies will do well, nevertheless, in regulation of the mortgage market, because they get a lot of support from the two main trade associations they are in, because they can work very closely together, and their customers want to continue buying products from them, but regulation certainly does not make it easier.

MR LOVE: The mutual sector is now in comparison with the rest of the financial sector relatively small. The FSA has to deal with all of them. Is there any concern that they might not be as sympathetic to mutual issues, and they may look more to the mainstream, if I can put it that way, in terms of regulation and that therefore you may be disadvantaged?

MR COLES: That is a concern that we are always alert to. Under the old legislation the Building Societies Commission had as one of its objects to promote building societies. Clearly the Financial Services Authority, which regulates a whole wide range of things, cannot possibly promote building societies.

I would not go along with the line, however, that the FSA is anti-mutual. I do not think that is the case. I do not think any action the FSA could conceivably take would be a factor that would cause a building society to convert.

DAVID TAYLOR: I represent a seat in north west Leicestershire and one of the odd cases I suppose is that within just a few miles of where I live there are three tiny building societies, Shepshed, Earl Shilton and Loughborough, and all three are micro societies by normal standards. Are they somehow threatened by the new Financial Service Authority requirements to which you have just referred?

MR COLES: There is a risk that small institutions are threatened by the increased legislative burden. I do not want to speak on behalf of those three but societies generally are working together. There is an organisation called Mutual One which is a grouping together of eight building societies that when the Financial Services and Markets Act was first introduced in 2001 put together a compliance manual, and that was purchased by about 50 different building societies and that clearly included some of the larger ones, so that avoided the need for each individual building society to work extremely hard in recreating the wheel, and some of the work we do at the BSA has exactly that objective. So if the societies work together they can reduce the potential threat they face. They can never remove it because you have to make sure that the way you sell mortgages and the way you run your business is totally compliant.

DAVID TAYLOR: There is intermittent interest in the *Mail on Sunday's* financial section in the transparency and accountability in small building societies in particular, and the suggestion is - and I am not at all referring to the building societies I have just mentioned - that there can be a tendency in small societies for the senior staff to construct pay packages and benefits systems which reward them out of all proportion to the success of the society or the contribution that they make as key people. Do you think that is a fair criticism that is made?

MR COLES: No, I do not think it is fair.

DAVID TAYLOR: Would you agree that that has been the implication of some of the press coverage from time to time?

MR COLES: Certainly of some of the *Mail on Sunday's* coverage but I do not believe everything I read in the *Mail on Sunday!*

DAVID TAYLOR: Nor do I. I am asking these questions because they deserve to be asked.

MR COLES: Absolutely right. I think the degree of openness and member input into remuneration packages has changed markedly over the last two years and will over the next two. It is certainly the case that the large societies have led the way on disclosure and on voting, but it is moving down through the sector. Last year five building societies had a vote on directors' pay; this year it was eighteen. I was with a very small society last week speaking at their local business club, and they have said they will be disclosing and having a vote next year and they are in the smallest ten. I think the situation is changing very significantly and all of those things will be open. Members will be able to examine them carefully and express their view, and I would guess almost all building societies will be disclosing and having votes within a couple of years.

DAVID TAYLOR: Is there any point in having large numbers of "Tiny Town on Trent" building societies in the modern world? There is the inevitable pressure to collect together for security and for mutual compliance reasons and so on, but is there any value in the micro societies?

MR COLES: I think there is. Do not forget that below the building society sector there are about 600 local deposit-taking institutions in the United Kingdom. They are called credit unions --

DAVID TAYLOR: I am a director of one.

MR COLES: -- and it is government policy to promote growth of these credit unions. As I said, if you look at why it is important that building societies exist, it is a question of local decision-making, local management, local accountability, local knowledge of the market, and there is every case for some of those smaller building

societies continuing, and if you look at the record of some of the smallest ten building societies last year, they exhibit some of the most rapid growth rates, in fact.

DAVID TAYLOR: I might have asked you about who benefits from demutualisation but maybe, if you have not already covered that in your earlier answers, a written response at a later date will be most welcome.

CHAIRMAN: I think you have covered it. There may be one or two other angles and we may write to you for a written response. I am conscious of the fact that we could be constrained by the division bell so thank you, Adrian, for coming here today and answering our questions.