



The All-Party Parliamentary Group  
**for Building Societies & Financial Mutuals**

# The All-Party Parliamentary Group for Building Societies & Financial Mutuals

**Short Inquiry**

December 2004

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## The All Party Building Societies and Financial Mutuals Group Inquiry Panel

The All Party Building Societies and Financial Mutuals Group consists of 164 Members from both Houses of Parliament.

The Purpose of the Group is to discuss and support building societies and financial mutuals.

Listed below are all the Members of the Group who sat on the Inquiry.

|                                     |                           |
|-------------------------------------|---------------------------|
| Adrian Bailey MP – Chair            | West Bromwich West        |
| Sir John Butterfill MP – Vice-Chair | Bournemouth West          |
| Dr Vincent Cable MP                 | Twickenham                |
| Elfyn Llwyd MP                      | Meirionnydd Nant Conwy    |
| Peter Pike MP – Secretary           | Burnley                   |
| Joan Walley MP                      | Stoke-on-Trent North      |
| Bill O’Brien MP – Treasurer         | Normanton                 |
| Andy Love MP                        | Edmonton                  |
| Ken Purchase MP                     | Wolverhampton North East  |
| David Drew MP                       | Stroud                    |
| David Taylor MP                     | North West Leicestershire |
| Mark Lazarowicz MP                  | Edinburgh North and Leith |
| Linda Gilroy MP                     | Plymouth Sutton           |
| Sally Keeble MP                     | Northampton North         |
| Baroness Maddock – Vice-Chair       |                           |

## Introduction

In March this year, following the publication of the Penrose Report, Ruth Kelly MP, the then Financial Secretary to the Treasury announced that the Government was going to conduct an independent review, Chaired by Paul Myners to look into the corporate governance of mutual life offices.

In July, following the publication of the Myners consultation document, The All Party Building Societies and Financial Mutuals Group took a decision at its AGM to carry out a short inquiry into the extent to which mutual businesses contribute to the economy and society.

The All Party Group has one of the largest memberships in Parliament with 164 members from both the House of Commons and the House of Lords. The Group undertook to build on this significant interest to examine many of the related issues not explicitly covered by Paul Myners' terms of reference, and conduct a Short Inquiry.

Evidence was taken in select committee style in three sessions, with invitations extended to witnesses from the existing financial mutual sector, to previously demutualised building societies and interest groups. All oral evidence was recorded verbatim. We also invited organisations to submit written evidence. A list of those who submitted either verbal or written evidence is recorded in the appendix to this report.

We embarked upon this Inquiry in order to give everyone – not only the largest financial mutuals but also all interested parties across the financial sector – the opportunity to contribute their views. We accepted the fact that the financial press would want to report on the Myners Review but we felt it necessary to get a feeling for some of the arguments for or against the presence of mutuals in the marketplace before Myners was published.

I would like to thank all those organisations and individuals who gave evidence to our Inquiry. There is clearly a need for financial mutuals to change and modernise as we move into the 21st century. Some will change quicker than others but what cannot be denied is that there is a need for them to promote competition with plcs in the marketplace. Consumers deserve no less.

**Adrian Bailey MP, Chairman**  
December 2004





## **The Terms of Reference for the Inquiry were as follows:**

- Does an organisation's mutual status enable it to offer financial products at good value for money?
- Does the existence of mutual businesses have an effect on the products and behaviour of other businesses operating in the same markets?
- Do mutuals work to combat financial exclusion?
- Do they offer services to markets not served by other businesses?
- How important is the contribution of mutuals to community life (economic well being, community cohesion etc)?
- Regulation – does it lead to demutualisation?

## **Executive Summary – Conclusions**

### **Does an organisation's mutual status enable it to offer financial products at good value for money?**

Best buy tables, although only capable of providing a snapshot view of product and provider performance can be usefully viewed over longer periods to reach meaningful judgements about value for money to consumers.

The Inquiry found that mutuals consistently perform well in these comparison tables, indicating that they do in fact provide value for money to consumers, and more so than plcs.

The Inquiry found that mutuals are also capable of operating as efficiently as proprietary companies with no evidence that they have higher cost ratios.

It is clear that mutuals, *ceteris paribus*, have an advantage over proprietary businesses in that they do not need to service shareholder capital. The evidence from the Best buy tables, shows that this benefit is passed on to consumers in the form of better value products.

### **Does the existence of mutual businesses have an effect on the products and behaviour of other businesses operating in the same markets?**

A compelling case can be made for the pro-competitive presence of mutuals in the marketplace.

This is beneficial to consumers but would be more so were mutuals more effective at marketing their advantage. Mutuals face stiff competition in the marketplace and they will need to continue to deliver better performance than plcs because people will not choose to do business with them out of sentimentality. Additionally small mutuals must concentrate on joint initiatives to manage the risks present in these highly competitive markets.

There appears to be good evidence that the existence of mutuals tempers the profit-taking instincts of proprietary financial services providers. This comes about by providing competition in the way described in chapter 1. By exploring the experience of demutualised former mutuals, we can see how their behaviour has altered. They have become less competitive, in fact, something not expected as a result of privatisation.

Indeed, although such plc operators will over the short-term, be able to lead markets, the long-term view is that they cannot offer consistent value for money to consumers because of their capital costs. Ultimately, they will recoup any discounts they offer through higher charges to consumers.

### **Do mutuals work to combat financial exclusion?**

Mutuals are well placed to provide financial services to citizens on lower incomes and the financially excluded. The importance of low value but consistent savings and investment policies should not be underestimated in the drive to encourage a prudent attitude towards future financial planning.

For many years this has been maintained through local contact and cash collection services, particularly in personal insurance services. We should expect, however, that this effect will continue to be eroded as regulation increasingly limits the ability of such staff to offer advice and sell products.

Although the Inquiry understands that it is necessary to protect consumers, we should be concerned that they are able to access financial services at all. It is likely that such low-volume and low profit customers will not be of interest to the new marketplace, and that this challenge should be faced directly by the FSA in seeking to alleviate financial exclusion.

We applaud the positive approach mutuals have made with Child Trust Funds. Clearly, mutuals are keen to show their credentials in tackling financial exclusion and we would expect them to be in tune with the needs of many communities.

Some efforts are being made to improve financial literacy and access to services through local branch networks. Yet, as with the industry in general, more effort is required to ensure that Financial Services products are accessible to all.

### **Do mutuals offer services to markets not served by other businesses?**

The mutual sector is dominated, in size at least, by a small number of large businesses. However, the role that very specialist and small-scale mutuals play is not to be underestimated. Many specialist markets are served solely by such organisations, with little or no interest from their proprietary competitors. Without mutuals many of these services would cease to exist.

It is important that small mutuals work collaboratively to meet the challenges of the consolidating financial services markets, and a number have shown the way in this. It is also important that government and the regulator understand the unique value that such organisations provide to a rich and diverse marketplace.

### **How important is the contribution of mutuals to community life (economic well-being, community cohesion etc)?**

Mutuals are committed to supporting the communities in which they operate. The fact that their headquarters are regionally based and not just in the city of London brings them closer to their customers.

Mutuals play an important part in their communities because many of them remain close to their founding principles.

It is also impressive that mutuals contribute more on average to charitable and other good causes than do their plc counterparts. Much of their work is to be commended.

One theme running through this Inquiry has been the acceptance that mutuals are often poor at communicating their benefits to the outside world.

This has undoubtedly led to them being regarded as a 'soft touch' by some financial commentators. We echo the finding of the Ernst & Young's report and call upon mutuals to work across their sectors to communicate better their unique value in society. If they fail to do this, they will have no one else to blame.

## **Regulation – does it lead to demutualisation?**

The evidence from previous demutualisations shows that they occurred against a backdrop of a relatively unsophisticated discussion about the merits of mutual status.

Accordingly, it can be shown that many people who would have personally benefited financially from remaining members of mutual societies have actually lost out in the long-term, despite receiving so-called windfall payments.

It is clear that the drive for new capital was the most important economic factor in the businesses seeking to demutualise. This has not changed. We find that Standard Life, just like its predecessors, is seeking demutualisation in order to access more capital. We also find that Standard Life is effectively the architect of its own predicament. Alone among mutual insurers, it followed a strategy ultimately doomed to failure. We do, however, give credit to its management for accepting responsibility.

We do not agree, however, that regulation has played a part in their decision to demutualise, or indeed any other former mutual. The overwhelming evidence is to the contrary.

We would caution the regulatory authorities, however, against a one size fits all approach to regulation. It is clear from our investigation that mutuals provide very important services to significant parts of our society. It is therefore equally important that the regulatory environment reflects their unique role and is sensitive to their needs. This is particularly important in relation to smaller societies.

# Chapter 1

## Does an organisation's mutual status enable it to offer financial products at good value for money?

### Introduction

Consumers of financial services products have become increasingly sophisticated in recent years. Whereas in the past, many customers remained loyal to a single supplier for many years, it is now increasingly common for consumers to shop around for the best deal – at least within the cost constraints allowed by such activity.

An industry has now grown up around the presentation of regular comparisons between products, epitomised by the growth in 'best buy' tables in the financial press.

Best buy tables are often used as a simplistic measure of a company's performance in the marketplace. The Inquiry wanted to understand why mutuals often appear at the top of these tables.

Is it merely the result of clever marketing, or could it be argued that plcs are inherently at a disadvantage in competing with mutuals? And if this is indeed the case, could this be attributed to their need to replenish the confidence of shareholders through dividend payments?

And if this advantage does indeed exist, if we look right across the piece at basic financial services and the sorts of products that the average middle England consumers would buy, is there anywhere where that advantage does not apply?

Alternatively, is it just that mutuals operate best in niche markets, which actually makes good business sense regardless of the corporate form employed?

### Evidence Taken

#### Do mutuals have an inherent advantage?

In a table of the 35 top mortgage lenders, 13 of the top 20 best value lenders over 12 months are building societies – *MoneyFacts*, (June 2004). Only one high street bank made it into the top 20 (HSBC). (The survey shows the total interest paid on a £100,000 standard variable rate mortgage between 1 July 2003 and 30 June 2004).

*It is quite clear that mutuals do offer a significant advantage for consumers. The most recent figures from the Bank of England on the net interest margins on variable rate mortgages, the average bank charges 6.69 per cent and the average building society is charging 6.3 per cent. The same applies to fixed rate mortgages and savings accounts whether it is instant access or notice accounts or whatever across the board.*

*Mick McAteer – Which?*

The main reason cited for the mutuals advantage over their plc rivals is that they do not have to pay dividends to their shareholders. Even during the recession in the early 1990s, whenever Barclays Bank made a loss they still paid 40 per cent of their average profits over five years to shareholders in the form of dividends. We heard that there was no evidence that shows that banks are any more efficient in terms of cost income ratios to offset that dividend, so overall building societies have been able to pass on that marginal advantage to consumers in the form of lower mortgage rates and higher savings rates.

The Consumers' Association (2001) looked at the value to consumers of products offered by banks and building societies, comparing savings and mortgage interest rates and costs charged for maintaining an overdraft on a current account. They also conducted a customer satisfaction poll. The report concluded that if the Nationwide converted from being a mutual, savers and borrowers in the UK would pay an extra £33 billion over the subsequent ten years in higher mortgage costs and lost interest on savings. The Consumers' Association (2001) also concluded that 'mutuals have consistently delivered better value to customers', and that:

*'Building societies deliver better value for one simple, crucial reason. The priority of the shareholder-owned banks is to keep their shareholders happy by paying large dividends, and increasing profits. For example, we calculate that for every £100 in after tax profit the banks make, about £30-40 of that goes to shareholders as dividends. The only way the banks can maintain and increase those dividends is to make as much profit out of consumers as they can.'*

Nationwide Building Society in their written submission to the Inquiry stated that they calculate that they have delivered more than £3bn in pricing benefits to members since 1996. Within that figure, some specific examples of the ways in which they have been able to deliver good value products to their members include:

- In 2001, Nationwide introduced their fair mortgage pricing strategy. This means no big discounts for new borrowers and better long term rates for everybody – all their mortgages are available to all their customers. This contrasts with many of their competitors who offer their best value deals only to new customers. With their basic mortgage rate currently 0.76% better than the market average, this guarantees good value for all their members.
- In the financial year ending April 2004, members benefited by a record £588 million through better interest rates and lower charges.

### **Are there other advantages?**

Thus, we heard that there are some inherent cost advantages in mutuals in that they do not have the burden of servicing shareholder capital. So, if a mutual is able to do as good a job as a plc then there is an extra potential bonus for their Boards to manage.

It was argued that there are inherent advantages in being a mutual. Firstly around business planning, mutuals are not prone to very short-term fluctuations in investor sentiment, that can sometimes force a management team to take the wrong short-term action.

The Inquiry's attention was drawn to a recent ICMIF survey, *Valuing our Mutuality*, which looks at eight years' worth of financial data for mutuals versus PLC competitors, and argued that mutuals are also on the whole more efficient than plcs.



*The research found that life company mutuals are at 13 per cent expense ratios whereas plcs are at 15 per cent on average, so there is a two per cent differential advantage and in addition to that the plcs have to pay their capital, which itself averages out at about two per cent of premiums. Thus there is almost a four per cent differential between mutuals and plcs, delivering a significant advantage to mutuals across the whole of Europe.*

*Shaun Tarbuck – CEO Association of Mutual Insurers*

*In terms of the expenses, to assume that plcs equal low expenses and mutuals equal high expenses is not borne out in practice. Police Mutual in terms of life and pensions has one of the lowest expense ratios, if not the lowest in the market. NFU Mutual would be not very far behind. On the general insurance side, it has the second lowest expense ratio of any insurance company in the market. I think all the carpetbaggers of ten years ago have given us a wake-up call and most of the mutuals left believe passionately that they have to earn, and demonstrate that they are earning their mutuality in the eyes of their policyholders and that means running the business efficiently.*

*Ian Geden – NFU Mutual*

## **Conclusion**

Best buy tables, although only capable of providing a snapshot view of product and provider performance can be usefully viewed over longer periods to reach meaningful judgements about value for money to consumers.

The Inquiry found that mutuals consistently perform well in these comparison tables, indicating that they do in fact provide value for money to consumers, and more so than plcs.

The Inquiry found that mutuals are also capable of operating as efficiently as proprietary companies with no evidence that they have higher cost ratios.

It is clear that mutuals, ceteris paribus, have an advantage over proprietary businesses in that they do not need to service shareholder capital. The evidence from the Best buy tables, shows that this benefit is passed on to consumers in the form of better value products.

# Chapter 2

## Does the existence of mutual businesses have an effect on the products and behaviour of other businesses operating in the same markets?

### Introduction

The Inquiry was keen to explore if there was any relationship between the existence of mutuals in the marketplace, and the behaviour of their proprietary competitors. In short, do mutuals' mere existence force others to be more competitive, and would their removal from the market lead to higher costs to consumers, in the form of greater profit-taking by plc's?

Does demutualisation therefore limit choice for the consumer? Or are consumers getting a better deal following conversion?

This led the Inquiry to explore the experience of previous demutualisations and the behaviour of stock market listed former mutuals. Had mutual society members been well served by demutualisation or has demutualisation limited choice for the consumer?

Ultimately, are there benefits to consumers in mutual societies maintaining their status?

Can small mutuals survive?

### Evidence Taken

#### Do mutuals make plcs more competitive for consumers?

It was argued that the mere presence of mutuals in the market place is a good check and balance on plcs, but that it is actually through their performance that they really do provide the ultimate constraint for plcs within the marketplace.

The House of Commons Treasury Select Committee as one of the conclusions in their report into demutualisation in 1999 argued that, 'the existence of a (building society) sector with potential for lower overheads, and therefore better rates for savers and borrowers, is both a valuable spur to competition and a very important part of the UK housing finance market.'

PA Consulting Group (2003) in an international study, found that the size of the mutual sector across countries has a direct influence on preventing banks making excess profits:

*"Profitability of the banking sector is inversely proportional to the market share of mutual banks within the banking sector"*

They found it was not just the fact that mutual banks took less profits themselves that lowered the average, but that mutuals create a competitive pressure on commercial banks to cut excess profits. In the fourteen countries analysed there was a strong correlation between the level of profits non-mutual banks made and the amount of competition they faced from the mutual sector. For example the Polish banking sector, where mutuals have around 5 per cent of market share, commercial banks make around three times the profits of the German banking sector, where mutuals have a 60 per cent market share.

It was argued that customers should be looking for better continuity rather than looking for short-term benefit or temporary appearance in a particular table.

*Being able to take a much longer-term view about for example, having a product that you are happy to sell to someone at the younger end of the spectrum because one looks at the value of the contracts that they will do with you over life, is the sort of thing that a mutual can do and it injects a bit of competition into the market place just by mere presence.*

*Mike Yardley – Royal London*

Nationwide believe that the existence of building societies has an effect on the products and behaviour of their competitors in the consumer financial services market. They suggest that there are two main ways in which building societies affect the products and behaviour of banks: the fact that they can price on their lower margins as a mutual, meaning that they force competitors to price more cheaply; and their presence in the market as consumer champions, which helps keep the banks under scrutiny to ensure transparency and fairness.

They cite the following examples:

- Nationwide's credit card users have benefited from the introduction of a summary box that makes it easier to compare cards from different providers. They were the first financial services organisation to publish the new table. Following their example and their drive for greater transparency, all credit card providers are now obliged to include a summary box in their literature.
- Nationwide fought hard against the proposal by Barclays to charge the customers of other banks for using its cash machine network. As a result of that campaign, cash machines at bank branches have remained free and charging machines have been required to display a sign warning consumers that they will be charged. Nationwide is now leading a campaign to promote further transparency in the market by introducing a Code of Practice for cash machines.

We heard that many have put the view that it was the carpetbaggers that made mutuals realise the apparent mutual advantage, but it was argued that that was not the case. A *Which?* Report comparing building societies against banks over the five years before most demutualisations occurred showed that even before the carpetbagging activity became very prominent, mutuals were still delivering that better value. (Reference - 'How mergers squeeze savers' *Which?*, February 1996 and 'Danger of building society conversions' *Which?* Consumer Policy Review, August 1996)

It was argued that this advantage was less clear-cut with regards to long-term savings, with-profits funds etc because investment reforms can cloud the issue. Even then, once one compares charges, and very importantly persistency rates, one finds that the mutuals seem to offer a better deal when compared to their PLC counterparts. *Which?* put a price on the cost of conversions to consumers and estimated that consumers now pay an additional three billion pounds a year in higher charges.

It was stated that management costs increase by 35 per cent upon the introduction of the requirement to pay dividends. The average margin between mortgage and savings rates in the converted building societies which are now plc banks, is 1.5 per cent. The average margin between mortgage and savings rates in mutual building societies is about 0.9 per cent, giving a 0.6 per cent advantage overall. That does not stop banks introducing products that get to the top of performance tables briefly, and building societies, even with their cost advantage, cannot offer the very best product in every single market segment all of the time.

### **Is mutuality just clever marketing?**

It was stated that 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.

However, they have not explicitly marketed themselves as such.

*It is interesting that not 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.*

*Adrian Coles – BSA*

### **Can mutuals continue to survive?**

The Ernst & Young report "Returning to Radicalism – Mutuality in the 21st Century" focused on the combination of consolidation in the financial services market place added to the very severe competition that now exists within the market and argued that the smaller regional societies would be placed under enormous pressure and that quite a lot of them might have to amalgamate.

There was an expectation voiced that there will continue to be mergers amongst building societies, but that the process of consolidation is slow. It was asserted that those societies that have survived the recession of the early 1990s, the introduction of the Financial Services and Markets Act and the introduction of mortgage regulations are tough and are well placed to continue in place, so there is a huge amount of resilience in the building society sector. The rate of consolidation will be relatively slow and certainly much slower than it has been in business sectors such as accountancy or consultancy.

However, it was also argued that although existing competition from mutuals was a good thing for consumers, it might also be good to see some bigger, stronger societies – such as half a dozen Nationwides rather than Nationwide and its smaller peers.

*I think it would be dreadful if we saw all the mutuals disappear. ...it would be good to see strong mutuals – whether they be life companies, building societies, friendlies, credit unions, whatever. In terms of competition a mixed market always works best with people who are at the top of their game and offering good products.*

*Steve Huxham – Investors Association*

## What does diversity bring to the market?

Evidence submitted to the Inquiry demonstrated that where there is a diversity of institutional types of organisations it brings competitive pressure.

We heard that the financial evidence was that the absence of diversity can encourage a herd instinct, and it introduces a levelling down of competition. If you have eight providers who all have to pay dividends to their shareholders, then they will all compete around the same level because they will all have to deliver this dividend to their shareholders. The very fact that you have a diversity of providers who do not have to pass on dividends to shareholders means they can then act as the champion for the consumer and can have a very strong proxy for competition in the market. It forces the plcs to improve their game in terms of delivering better rates for consumers. They are constantly chasing the mutual champion within the sector.

*That is why we are concerned about Standard Life demutualising, because the disappearance of a big champion within that sector is going to have long-term implications for consumers.*

*Overall, mutuals are winning back market share within the building society sector. The smaller mutuals are very successful in the life sector as well, but they are going to struggle to take on the big proprietary companies in the life insurance sector because of the concerns about financial security and because of the general confidence and trust issues that are affecting the life insurance sector. Rightly or wrongly, I think people will look towards big brands as being more stable and more secure and, therefore, more trust worthy, even though I think a lot of that trust would be misplaced.*

*Mick McAteer – Which?*

Police Mutual argued that the way they are structured only works because they are a mutual, they engage with their members, who contribute a lot to the organisation and they do this because they know that the benefits will flow back to their colleagues in a closed group. The members also understand that were Police Mutual to demutualise the whole of the Society would effectively cease. They feel that their philosophy and style of mutuality permits them to provide benefits to members under certain circumstances that do not strictly accord with the terms and conditions of any specific policy contract. For example when the 'Troubles' of Northern Ireland caused police casualties that affected morbidity and mortality experience, it was put to the delegates that this ought to result in members of the Royal Ulster Constabulary having their premiums rated to reflect the higher expenses. In the event the delegates showed their solidarity with their colleagues in the RUC by instructing the society to maintain a policy of charging standard rates to all members. That continues through today, so Police Mutual do not risk rate premiums for police personnel in high-risk occupations.

*Some economists will argue that it does not matter what form the organisation takes as long as there are plenty of providers. However, it is important to have diversity of institutions as well because it is clear that by having different forms of institutions you do bring a competitive pressure to bear on plcs. Even though there is still roughly the same number of providers in the mortgage market, we are now seeing what we call a levelling down of competition because there are fewer big building societies around.*

*Mick McAteer – Which?*

## Conclusion

A compelling case can be made for the pro-competitive presence of mutuals in the marketplace.

This is beneficial to consumers but would be more so were mutuals more effective at marketing their advantage. Mutuals face stiff competition in the marketplace and they will need to continue to deliver better performance than plcs because people will not choose to do business with them out of sentimentality. Additionally small mutuals must concentrate on joint initiatives to manage the risks present in these highly competitive markets.

There appears to be good evidence that the existence of mutuals tempers the profit-taking instincts of proprietary financial services providers. This comes about by providing competition in the way described in chapter 1. By exploring the experience of demutualised former mutuals, we can see how their behaviour has altered. They have become less competitive, in fact, something not expected as a result of privatisation.

Indeed, although such plc operators will over the short-term, be able to lead markets, the long-term view is that they cannot offer consistent value for money to consumers because of their capital costs. Ultimately, they will recoup any discounts they offer through higher charges to consumers.

# Chapter 3

## Do mutuals work to combat financial exclusion?

### Introduction

The Inquiry wished to explore the question of accessibility of financial services products to often hard to reach citizens, sometimes known as the 'financially excluded.'

These may be people without bank accounts, or little or no savings or pensions provision. It was deemed important to discover if mutuals were any more inclined to develop products for this section of the market than plc's were, and whether this was connected to the mutual nature of their business or other factors.

What are mutual societies doing to reach citizens with little experience of financial services?

### Evidence Taken

In a recent report by Dr Karl Dayson, 'Improving Financial Inclusion' it states, 'that building societies have long taken the challenges of financial exclusion very seriously. Historically most societies began in response to their members being excluded from affordable housing finance and societies have been a safe home for the savings of millions of low and moderately paid households for over 200 years. In facing up to contemporary financial exclusion building societies have preserved branches in isolated and deprived communities, while other societies have engaged in numerous financial inclusion initiatives.'

In their written evidence, Nationwide cite examples of where they work to promote financial inclusion:

- They offer two basic bank accounts that meet financial inclusion criteria and satisfy Government requirements to provide customers with access to financial services without the risk of getting into debt. They currently have more than 500,000 basic bank accounts. Everyone can have access to these accounts, as long as they can fulfil basic criteria, including proof of their fixed address and identity. As part of their support for Universal Banking, Nationwide's bank account is accessible through Post Office branches free of charge. They have also made a significant financial contribution towards the costs of the Post Office Card Account.
- Nationwide is also represented on, and gives considerable financial and other support to, a number of industry-wide bodies committed to promoting financial and social inclusion, including the Personal Finance Education Group (pfeg), the Citizens' Advice Bureaux, and the FSA's Financial Capability Working Group.

On the issue of disclosure of information and whether there is evidence that societies are serving financially excluded groups, research by Dr Dayson has suggested that much work remains to be done and that there was insufficient statistical evidence to support the argument that building societies were more inclusive than banks. However, there was considerable qualitative information to suggest that building societies were addressing aspects of the psychological aspects of exclusion. Examples of staff providing financial and non-financial support abounded.

Dr Dayson's report also revealed that most building societies had links with financial literacy and capability providers; the majority of these were with schools, though some also worked with organisations addressing adult financial capability. The proximity of societies to their community meant that they could respond effectively to local needs.

The Report discussed the partnerships with alternative financial providers and it was shown that building societies have not developed close relations with credit unions. Rather some societies sought to create savings and loans products in partnership with housing associations. The author welcomed this innovative approach as societies were demonstrating their capacity to deliver a different kind of service to those most in need.

Finally, the Report concluded that the challenge to building societies is to ensure that they articulate the extensive informal support that occurs within branches and collect data to demonstrate their effectiveness in addressing financial exclusion.

*One of the things that has saddened me over the years, given that the roots of Royal London has been very much in low to middle income groups, and some of the businesses that we have acquired along the way, such as United Friendly and Refuge, have also had their roots in that market place, is that it is harder and harder to service those lower income groups. The economics of the market place are very different now to perhaps ten, 15, 20 years ago. Some of that is regulation, some of it is charge capping that has taken place. So we have had to move away from that part of the market place because I suppose we sense that our overriding objective is to add value for our members and distributing in an uneconomic way is actually eroding value for members. We still have though about 600 people out there collecting money door-to-door cash collection business, so even though we are not selling new products into that market place we are still carrying on with that sort of service to many of these people who are financially excluded.*

*Mike Yardley – Royal London*

We heard that the Friendly Society movement has circa 6 million members across the country; generally speaking, they are more of the less well-off in society than the traditional plc customers. They perform a very clear role for them by providing simple savings plans that work for a lot of people. Many friendly societies continue to accept very low premiums, and a number of them still can provide face-to-face contact in spite of the costs it involves.

Professor Nigel Waite in his 2001 Report, 'Welfare and the Consumer Society' stated that, 'Given that the Financial Services Authority (FSA) has a mandate to address financial education and literacy, it would seem appropriate for it not only to encourage the diversity of provision that encourages Credit Unions and Friendly Societies to thrive, but also to facilitate awareness of their existence.'

*Professor Waite's Report* also concluded that Friendly Societies already possess competitive advantages and core competencies that enable them to empathise with those who are financially unsophisticated and lack self-confidence regarding financial matters.

*The other thing you have to be aware of is that mutuals do differ. If we are talking about social factors and encouraging savings amongst people who can least afford it, if you look at minimum opening balances there are a few mutuals who set the benchmark far too high, and getting back to your roots is a theme I am very fond of with the mutual movement.*



*A mixed market works best because it keeps everybody on their toes, but I think we have an opportunity going begging at the moment, and the mutuals ought to sharpen up their act and engage their members more properly, put them in the boardroom and make the directors more accountable and less bullet-proof.*

*Steve Huxham – Investors Association*

## **Child Trust Fund**

The Child Trust Fund, which is due to be introduced in early 2005 is an example of the Government's wish to instil a long-term savings culture in future generations.

This new product has been embraced by mutuals, who are likely to lead the market in retailing these new products. More than 60% of the providers are likely to be mutuals.

One particular mutual has taken the radical step of changing its name from the Tunbridge Wells Equitable Society to The Children's Mutual.

The Children's Mutual claim that they make it their business to help parents and other members of the family ensure that their children are financially well equipped for the future; they introduced their first savings plan for a child in 1948. Children's Mutual has been working with the Government, offering input and insight on the Child Trust Fund. This they believe has helped them to understand better the barriers preventing parents from giving their children a financial head start.

Children's Mutual are also working with the personal finance education group (pfeg) to help get the whole subject of personal finance into schools as part of the national curriculum.

Children's Mutual focus is firmly fixed on providing medium to longer term, flexible savings plans so that families can give their children a financial head start. They will continue to support families in providing children with a lasting lesson: appreciating the value of money. Children's Mutual's vision for the 21st century is to be the specialist provider of long term savings plans for children based on one of their defining principle of mutuality.

## Conclusion

Mutuals are well placed to provide financial services to citizens on lower incomes and the financially excluded. The importance of low value but consistent savings and investment policies should not be underestimated in the drive to encourage a prudent attitude towards future financial planning.

For many years this has been maintained through local contact and cash collection services, particularly in personal insurance services. We should expect, however, that this effect will continue to be eroded as regulation increasingly limits the ability of such staff to offer advice and sell products.

Although the Inquiry understands that it is necessary to protect consumers, we should be concerned that they are able to access financial services at all. It is likely that such low-volume and low profit customers will not be of interest to the new marketplace, and that this challenge should be faced directly by the FSA in seeking to alleviate financial exclusion.

We applaud the positive approach mutuals have made with Child Trust Funds. Clearly, mutuals are keen to show their credentials in tackling financial exclusion and we would expect them to be in tune with the needs of many communities.

Some efforts are being made to improve financial literacy and access to services through local branch networks. Yet, as with the industry in general, more effort is required to ensure that Financial Services products are accessible to all.

# Chapter 4

## Do mutuals offer services to markets not served by other businesses?

### Introduction

The origins of many mutuals are within groups demonstrating a strong local or special interest affinity. Today, this is reflected in the names of societies, which tend to echo their roots. For example building societies bearing the name of their founders' town or friendly societies dealing with specialist employment based affinity markets.

The Inquiry wished to consider whether this historical basis could be translated into a modern context, and specifically, if it still led to mutuals offering services to markets not served by proprietary companies.

Given the complex nature of financial services provision, is the continued existence of small, niche mutuals a good thing for consumers? And will these societies be able to survive into the future, offering relevant and value for money services?

Will this diversity continue by virtue of normal competition, the fact that mutuals may provide services of better quality at a lower cost, or is the consolidation of financial services in the marketplace a real threat to mutuals and, will therefore, more positive action need to be taken to ensure that they survive?

In short, are such mutuals, an anachronism?

### Evidence Taken

#### Are friendly societies an anachronism?

We heard that the benefits that friendly societies offer around price and value, is reflected in the best buy surveys. Friendly societies believe that it is important to maintain a close relationship with their customers through face-to-face contact and so unlike their plc rivals they are not looking to outsource their call centres to the Indian sub-continent. Finally, in summary it was argued that friendly societies concentrate on personal treatment of their customers by maintaining a high level of communication, and a strong understanding of their customers, which is a very different proposition to what plcs do, and one which still resonates very strongly now, as it did 150 years ago when these societies were set up.

It is recognised that such mutuals would be difficult to re-engineer from nothing today, but they can provide some very good services to the markets they serve.

*If you look at why it is important that building societies exist to ensure 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.*

*Adrian Coles – BSA*

### Affinity Based mutuals serving niche markets

*We are seen as being part of the police family. Because we are seen as being controlled by them for their own benefit they would see us as being part of the police service of the UK rather than us being a commercial financial services company. We have a group of people who have got a strong common bond and interest, which means that they are prepared to take a different view to how we deal with risks and returns than perhaps non-related parties may be prepared to do. We are governed by a combination of very senior police officers and also delegate members, so they control the organisation and determine our strategic direction and what we do, which reinforces this thing about ownership and control, which is so important to us. Because we have a closed group of people we can take a different view on things, and I will give you some specific examples. When the government decide to send troops and police officers out to Iraq they are able to mop up behind and ask questions about whether adequate life cover is available to people who are posted over there, which the relevant departments had not necessarily thought of. So in some of these areas they can take a different view to a commercial organisation.*

*Graham Berville – Police Mutual*

Evidence to the Inquiry from Police Mutual demonstrated that they were set up to serve a particular group of people and they argued that if they were to demutualise they would cease to exist. It is therefore interesting to look at similar mutual societies to look at the types of customers they have.

Two particular mutual societies that were set up to serve a certain group of people are the Dentists' Provident Society and Teachers' Provident Society.

Dentists' Provident Society dates back to the early years of the twentieth century when there was increasing concern amongst dentists about the financial risks associated with disability due to sickness or accident and the provision of a secure income in old age.

Today, Dentists' Provident Society remain a society run by dentists, for dentists and although membership is no longer restricted to members of the British Dental Association, they remain the only organisation in the country providing income protection benefits exclusively for dentists.

Similarly, Teachers' Provident Society was established in 1877 to provide a service needed by a particular group of people. Teachers' Provident Society is now the fifth largest friendly society in the UK. They manage over £836 million (as at February 2004) on behalf of their customers.

The company was established as a friendly society to provide sick pay, annuities and endowments for people in the education profession, in a time when teachers received no financial help – such as pensions – from the Government. By providing schemes that everyone could afford they established a financial bedrock upon which people could plan for a dependable future.

Another example of a hybrid mutual is Benenden Healthcare.

The Society was formed in 1905 to help Post Office workers, who were suffering from tuberculosis (TB), which was rife among sorting clerks.

All members would contribute a small weekly amount to a fund. It would be used to help their colleagues or themselves if they were unlucky enough to suffer from TB by providing health care.

Benenden are still a mutually owned and operated healthcare organisation providing low cost back-up healthcare to over a million members.

These examples are all long-established societies but newer mutuals are being set up to reflect changes in society.

A good example of this is the Ecology Building Society, which was founded in 1981. Ecology Building Society is a mutual organisation, who use the money deposited by their savers to grant mortgages on properties and projects that help the environment.

Ecology have grown steadily since their formation, as more people decide to put their savings to this use. Based in Yorkshire, their savings and mortgages are available across the U.K.

Their AGM is held in a different part of the country each year, at a venue of environmental interest. This enables members living around the country to attend.

*We understand farming and the rural market better than anybody else because that is all we do. We are focused on the rural affinity market. We have a network of retail outlets literally from John O'Groats to Land's End. We will do classes of business for the rural population that virtually nobody else will do. Foot and mouth insurance: at the height of the 2002 foot and mouth crisis some of the companies who were providing foot and mouth cover stopped renewing it. We carried on renewing policies all the way through the crisis. That is because we are very close to our customer base, we have an affinity to it and because the people who are insured with us are effectively our owners. I do not think a plc would have done those things.*

*Ian Geden – NFU Mutual*

## Conclusion

The mutual sector is dominated, in size at least, by a small number of large businesses. However, the role that very specialist and small-scale mutuals play is not to be underestimated. Many specialist markets are served solely by such organisations, with little or no interest from their proprietary competitors. Without mutuals many of these services would cease to exist.

It is important that small mutuals work collaboratively to meet the challenges of the consolidating financial services markets, and a number have shown the way in this. It is also important that government and the regulator understand the unique value that such organisations provide to a rich and diverse marketplace.

# Chapter 5

## How important is the contribution of mutuals to community life (economic well-being, community cohesion etc)?

### Introduction

The previous section looked at the community roots of mutual societies. The Inquiry wished to examine whether mutuals offered anything different to community life – in terms of economic well-being, social cohesion or anything else that will be lost if mutuals were absent from the market.

Alternatively, is this an old-fashioned view based upon the way the mutual sector was rooted in communities when it was founded, but is not very relevant any more?

Indeed, should mutuals in general be doing more to provide non-financial benefits for their members, and make it clear that there are real benefits in mutual organisations?

### Evidence Taken

#### Locally based businesses

**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.**

*Adrian Coles BSA*

Mutual organisations tend to be rooted in the communities they serve. Evidence was submitted that suggested one difference between a mutual and a privately owned company is that a mutual is more likely to maintain its operations in the area in which it was first created. In fact every government region in the country has at least one mutual based within its territory. While the vast majority of plcs have their headquarters in the City of London and its environs only around 2% of mutuals are based in the area. Rather than being based in London the majority of mutuals are located in some of the less well of regions in Britain.

Bill Jamieson in "The Scotsman" (16 January 2004) pointed out that of the Scottish mutual insurance societies that de-mutualised, none of them any longer has their main offices in Scotland. For example, Scottish Amicable was taken over by Prudential and no longer has a base in Scotland, and Scottish Mutual was taken over by Abbey Group, which in turn closed all its Edinburgh offices.

A large part of the wealth generated by a mutual may thus be irreplaceable for a local community, in that if the organisation de-mutualised, it may also relocate.

Mutual businesses may thus often provide valuable services and jobs in areas that might not otherwise be served. One example of this is in the banking sector, which in recent years has witnessed a rapid fall in the number of branches throughout Britain, with around a fifth of all bank branches being closed between 1995 and 2001. These closures are often in the most deprived areas where there is little alternative provision of financial services. Building societies however have been more likely to keep their branches open than banks: in the last ten years 2.4% of building society branches closed as against 24.9% of bank branches (Building Societies Association submission to the Treasury Select Committee ). In fact, of the banks with the worst record for closing down branches, three of the top five were former building societies (Which?).

This is supported by a recent survey of mutual organisations *Mutuals and their Communities* (Mutuo, December 2004), which stated that among all the building societies questioned, all stated that they would be more likely to keep an outlet open in an area where an equivalent company would not.

The ability of mutual organisations to keep branches open is true for both multi million pound national organisations such as Britannia and Nationwide Building Societies and smaller firms such as Tunstall Assurance Society, who are one of the only two life assurance offices left in Stoke on Trent (the other also being another mutual). Indeed, Yorkshire Building Society has been actively trying to acquire branches from a former building society that had started closing down their branches after de-mutualising.

If one looks at building society branch closures, overall since 1995, building societies have closed a total of 111 branches (4%) compared to banks who have closed 3,021 branches (22%) and the Post Office with 2,990 closures (15%) [Figures obtained from the BBA's *Banking Business: The Annual Abstract of Banking Statistics*, Vols 18 & 21]. Dr Dayson's Report stated that previous research by Marshall et al in 'The Contribution of British Building Societies to Financial Exclusion' in 1999 had highlighted how building societies were much less likely to close branches than banks. He wanted to see if this was still the case and his findings suggested that building societies were still reluctant to close branches and most intend to engage in some form of consultation prior to any final decision being taken.

Nationwide have also underlined their commitment to keep their customer service centres in the communities which they serve. This year they are opening a new call centre in Sheffield, which adds to their existing ones in Swindon, Northampton and Swansea.

## Support for Charity

Nationwide's portfolio of local, regional and national community activity amounted to £2.64 million in financial year 2003-04.

Many building societies state that they are committed to continuing to support the communities where they operate and believe that this is an essential part of their mutual status and history. Other evidence was received that stated that because of the social purpose inherent in many mutuals, they tend to give greater support to local charities and other such bodies than do private companies. The mutual sector as a whole gives well over 1% of its surplus to the local community, therefore beating the generally accepted benchmark for good corporate governance. This is not just in terms of cash, but also various support 'in kind', such as use of premises, and encouraging staff to spend time supporting local charities and other initiatives.

Business in the Community has awarded several mutuals with their Percent logo, which is given to any firm that donates at least one percent of their pre-tax profits to charity. A Report, *Mutuals and their Communities* (Mutuo, December 2004) suggests that the mutual sector as a whole deserves the Percent logo, with mutual organisations giving over 1.35% of their pre-tax profits to directly support their local communities (as against an average of 0.8% for the top 100 leading quoted companies). (The Guardian Giving List 2003).

Their survey identified three broad areas to which mutuals contribute: supporting disadvantaged groups and the socially excluded; education and life long learning; and local community events, projects and local sports teams. The biggest contribution was to local community events, projects and local sports teams, attracting almost half the total support, reflecting the local ethos of many mutuals.

Many building societies contribute to their local communities in terms of sponsoring boys and girls football leagues and agricultural shows, sending around their charity buses to charitable events, supporting local theatres 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.*

*Adrian Coles – BSA*

Ernst & Young were critical in their written submission to the Inquiry of the ability of mutuals to communicate this non-financial value to their customers, " We regard this as a bigger challenge to the Mutual sector than improving efficiency, because if the sector is unable to demonstrate the benefits of mutuality to Members and customers, in our opinion it will ultimately wither. Indeed we were surprised by the relative lack of performance measurement tools beyond standard accountancy metrics – balanced scorecards; customer and staff satisfaction measures; member and community value metrics; CSR frameworks for example – generally throughout the sector although there are notable exceptions."

## **Conclusion**

Mutuals are committed to supporting the communities in which they operate. The fact that their headquarters are regionally based and not just in the City of London brings them closer to their customers.

Mutuals play an important part in their communities because many of them remain close to their founding principles.

It is also impressive that mutuals contribute more on average to charitable and other good causes than do their plc counterparts. Much of their work is to be commended.

One theme running through this Inquiry has been the acceptance that mutuals are often poor at communicating their benefits to the outside world.

This has undoubtedly led to them being regarded as a 'soft touch' by some financial commentators. We echo the finding of the Ernst & Young's report and call upon mutuals to work across their sectors to communicate better their unique value in society. If they fail to do this, they will have no one else to blame.

# Chapter 6

## Regulation – does it lead to demutualisation?

### Introduction

Since the establishment of the Financial Services Authority in 1997, the issue of regulation in financial services has been highly topical. Indeed, in the last year, regulatory and governance issues have again come to the fore, following the Penrose report, which provides much of the backdrop to the Paul Myners inquiry.

Standard Life, the largest UK life mutual has cited the regulatory impact as a key factor in its decision to seek demutualisation. The committee was extremely concerned to examine if their claim that they were forced to recommend demutualisation partly as a direct result of the FSAs “Realistic Reporting Regime.”

Do societies believe that the FSA is pro or anti-mutual? Did they believe that they are being badly or overregulated or do they believe that they are being treated fairly by the FSA?

The Inquiry also wanted to know if regulation was the driving force behind previous demutualisations such as Abbey National, for example.

The Inquiry wished to come to a clear view on this matter and discover whether regulation was indeed a cause that could lead to mutual societies converting to PLC's.

And if, as has been argued, demutualisation has effectively been forced upon former mutuals by circumstances beyond their control. Why then, do some mutuals persist in maintaining their mutual status?

On the other hand, if demutualisation has not been driven by regulation, then what other factors have caused these decisions? Is it the case that the interests of directors have been placed before the longer-term interests of members in some of these companies? And what has this meant for consumers – what are the costs versus the benefits?

Finally, what are the intentions of the remaining mutual societies? Are they committed to maintaining their mutual status?

## Evidence Taken

### Previous demutualisations

We were keen to learn about the experience of previously demutualised organisations, on why they demutualised and their experience since demutualisation. As the House of Commons Library Research Paper (The Industrial and Provident Societies Bill – Research Paper 02/08 23 January 2002) stated with reference to the demutualisations of the Halifax, the Woolwich and the Alliance & Leicester in the mid 1990s that ‘these conversions were typically accompanied by substantial ‘windfall’ payments to some members of these societies.

Those in favour of demutualisation spoke of the need for building societies to diversify, to access corporate capital in order to compete with the banks and of the limited value of membership rights when they were locked up in large building societies with millions of members. Those against spoke of the lower cost of capital to societies (who do not need to reward shareholders) and of the positive alignment in mutual building societies of the interests of members and customers. But for many the issues were narrowly focused on windfall gains; on the fairness of distributing accrued surpluses only to current members; on complex rules which restricted the entitlement of some current members to a distribution; and on the desirability of dismantling organisations which had been built on a distinctive mutual basis in order to attain short term gains.’

Abbey National demutualised in 1989 and there was not another demutualisation until Cheltenham & Gloucester in 1995. It was argued by one witness that what Cheltenham & Gloucester showed was that if you voted in favour of demutualisation you got ‘£2,000 for nothing’ which then put huge pressure on the directors of many institutions to deliver ‘£2,000 for nothing’ to their members. It was a fashion, which 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.

Two demutualised organisations, Abbey and Bradford & Bingley were invited to give evidence to the Inquiry. Bradford & Bingley declined our offer without explanation but Abbey did submit written evidence. Abbey wrote, ‘At the time Abbey demutualised their PLC status gave them greater benefits in the marketplace than they had as a mutual. Since that time, however, the legislation governing building societies has become less restrictive. Most significantly the Building Societies Act 1997 allows building societies an almost unrestricted programme of diversification. There now exists a more level playing field between mutual and non-mutual providers of financial services, all now regulated by the FSA.’

As the same House of Commons Research paper said, ‘Demutualisation has also occurred at many formerly mutual insurance companies: the arguments for demutualisation in these cases have tended to focus on the need for greater capital. In both insurance companies and building societies expectations rapidly developed of further conversions and windfalls. This led to much speculative account opening by individuals – dubbed carpetbaggers – who hoped that the acquisition of membership rights would in future entitle them to windfall distributions. While the rights and wrongs of carpetbagging are disputed, the sudden growth in new accounts (often with the minimum opening balance) caused significant disruption to the operation of many mutuals.’

*I think it is also worth pointing out that... most of those decisions came from the boards concerned. I cannot see that any demutualisation efforts in the future could possibly come from members. They will come from the board – whether it is demutualisation or a merger, as we saw recently with the Portman and the Staffordshire.*

*Steve Huxham – Investors Association*

## Standard Life

Standard Life, the UK's largest mutual insurer has announced its decision to seek demutualisation in 2006, even though they successfully fought off a hostile demutualisation bid in 2000.

Fighting the anti-demutualisation campaign in 2000 cost the Company £11 million. The successful demutualisations of Norwich Union and the Halifax cost their members £120 million and £160 million respectively. The Inquiry wanted to know the expected impact of a successful demutualisation on Standard Life's members. Standard Life confirmed that the likely cost would be in excess of £100 million.

Standard Life also wrote that the industry has undergone a regulatory reaction to the failures at Equitable Life and in some products. That regulatory reaction they argued has itself been a driving force in their demutualisation. That, together with the new European solvency regulations, has made capitalising an insurance business much more difficult. Effectively, they require more capital per unit of business written now than in the past.

Another driving influence, they argued, is product regulation. They claimed that they have had sales process regulation for some time, but since 2000, they have had to deal with a form of product regulation, the stakeholder product, which had been introduced with a price cap. Now, with Sandler compliant products, there is a whole new suite of products that are price capped. It is a form of product regulation. All these, it was said, are important influences and have affected Standard Life this year.

Standard Life also wrote the financial benefits of mutuality into their policy projections for policyholders and as a result of the FSA realistic reporting regime was asked to make capital provisions for these projections.

*We blame ourselves, I think, for not seeing the full impact of these new solvency regulations soon enough, we did not respond to them early enough and we had some major changes to make around about the turn of the year. Certainly I am not blaming the FSA.*

*Sandy Crombie – Standard Life*

*I think Standard Life made decisions in the past that have been overtaken by events which, with the benefit of hindsight, they do not look like good decisions.*

*Sandy Crombie – Standard Life*

*Clearly even in the short term I suspect any windfalls that members might get if they make it to Initial Public Offering will not in any way compensate for the loss of value of the company since the last carpet-bagging attempt in 2000.*

*Steve Huxham – Investors Association*

## Capital Adequacy, Realistic Reporting Requirements and Standard Life.

Of Standard Life, it was said that there were a number of factors, which came together, which caused the outcome. They pursued a policy of having a high equity-backing ratio and sticking with it when markets fell when others were getting out of equities; that needs capital. They had diversified over recent years, both into new business areas and overseas and that needs capital. They had written large volumes of new business over the preceding two or three years, which needs capital. They

had certainly been putting high guarantees in their products, which needed capital, and there were some practices that they had been pursuing in terms of reflecting benefits of mutuality into their product pricing, which subsequently it appeared needed more capital than maybe they had thought.

We therefore feel that there were a number of coincidental issues, which came to a head with Realistic Reporting. They should have (a) come to a head anyway; and (b) they could have happened to any company – it was not a mutual specific issue.

*But most businesses that enjoyed the new Realistic Reporting Requirements had been there for at least six months or a year beforehand and some of this stuff was fairly evident really. We had done a first stab at the half year, so why some of these issues came to a head at the end of the year we could not work out.*

*Graham Berville – Police Mutual*

One witness stated that all insurers, whether they are mutuals or plcs, in terms of projecting policy benefits have to project forward on a standard basis and they have a roll-up of four, six or eight per cent. The only difference is really in respect of expenses, the charges taken out of the business. As he understood it, Standard Life were including a three-quarters of a per cent benefit of mutuality in their roll-up, which was something that no other mutual did and, quite rightly, I think, the FSA turned round to them and said, “If you are projecting that then you need to reserve for it”.

*From our point of view we think it was much more just around capital. We do not see anything in a Realistic Reporting Regime that is a problem for a company that understands its finances, has taken the right sort of management actions in the past.*

*Mike Yardley – Royal London*

Both Equitable and Standard in different ways had made commitments about what they were planning to do, and the FSA called them to account to reserve for those commitments, and as a consequence they found that they needed extra capital so to do.

*Now, I would argue that those commitments that they made were not pursuing mutual strategies. They were doing things that were almost inevitably bound to produce situations which would mean they would run out of capital. All that has happened with the FSA regulation is that they have been asked more explicitly to reserve for the commitments they have made.*

*Malcolm Berryman – Liverpool Victoria*

Strong arguments were put to the Inquiry that the forces for demutualisation lie around the availability of capital, and the absence of economies of scale for smaller societies, although one of the witnesses stated that he was not sure that the economies of scale argument is quite as important as people make out.

*We just won a technology-based solution this week to IFAs that put us in the top six for a particular type of business and we are a small-to-medium sized society, but it is the use of technology and the use of innovative product design, etc. You can still make ground on those sorts of issues.*

*Steve Burnett – Royal Liver*

## Regulation

As a matter of fact, there is no distinction made in the requirements that the FSA makes between proprietary and mutual businesses.

Although regulation is not seen as a force for demutualisation, except by Standard Life, it is an area of concern for mutual societies. The BSA surveyed its members on the number of consultation papers from various organisations that they were responding to in April 2004. The total came to approximately 50 papers that they were looking at from the FSA, HM Treasury, the Inland Revenue, from Europe, from the Banking Code Standards Board and the DTI, that total excludes health and safety, environment and other non financial issues.

They felt that there is a huge regulatory burden and it would be bad for the consumer if the only institutions that could survive in the modern markets were those with big compliance departments. The BSA 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 profits from them.

There is clearly a risk that small institutions are threatened by the increased legislative burden, 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 which was purchased by about 50 different building societies including some of the larger ones. Mutual One also provides services such as internal auditing and purchasing to some 40 Societies on a fee basis.

One important structural change following the establishment of the FSA was highlighted to the Inquiry. 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 all financial institutions cannot possibly promote just building societies and this function has been lost.

**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.**

*Adrian Coles – BSA*

The Association of Friendly Societies (AFS) do not believe that regulation is anti mutual in any way. However, there are effects which fall disproportionately on friendly societies and building societies, means that the level of regulation is not proportionate to size. The one-size-fits-all approach to the majority of regulation falls disproportionately on smaller organisations, and that can limit their ability to carry out the very good work that they do.

It was also said that, in fairness to the FSA, on the one hand they are regulating organisations, such as the Prudential, who can seek to raise a billion pounds worth of capital, at the same time as they are also regulating a friendly society or a building society, which has no immediate external access to capital. So despite the regulation not being different there is a difference of culture and treatment because they would feel themselves more at risk in dealing with an organisation, which is not able to raise capital externally. Thus there is an effect that is not part of regulation but it is in the way friendly societies and building societies are treated by individual supervisors in the regulator.

## Legislation

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 body.

*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 £2000. 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 £2000 apparently for nothing?"*

Adrian Coles – BSA

The BSA also claimed 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 should be corrected.'

It was therefore argued by the BSA that it was the directors who have led the process of demutualisation. In the case of Bradford and Bingley, had that board been against demutualisation it could have prevented the demutualisation of that organisation. There are no examples where the members have led the demutualisation process.

## Consolidation

Graham Berville, Chief Executive of Police Mutual felt that the demutualisation trend is part of a wider trend to consolidation, which has affected the proprietary sector as much as it has affected the mutual sector, with a perhaps inevitable push towards scale to get down costs. The UK's leading provider, which is Aviva, is a significant consolidation of proprietary companies, but the macro economic factors are absolutely the same. He agreed with Mike Yardley (Royal London) that it is primarily driven by capital, whether that is the new business strain or to meet new solvency requirements. Either way, it is fundamentally driven by capital.

## Conclusion

The evidence from previous demutualisations shows that they occurred against a backdrop of a relatively unsophisticated discussion about the merits of mutual status.



Accordingly, it can be shown that many people who would have personally benefited financially from remaining members of mutual societies have actually lost out in the long-term, despite receiving so-called windfall payments.

It is clear that the drive for new capital was the most important economic factor in the businesses seeking to demutualise. This has not changed. We find that Standard Life, just like its predecessors, is seeking demutualisation in order to access more capital. We also find that Standard Life is effectively the architect of its own predicament. Alone among mutual insurers, it followed a strategy ultimately doomed to failure. We do, however, give credit to its management for accepting responsibility.

We do not agree, however, that regulation has played a part in their decision to demutualise, or indeed any other former mutual. The overwhelming evidence is to the contrary.

We would caution the regulatory authorities, however, against a one size fits all approach to regulation. It is clear from our investigation that mutuals provide very important services to significant parts of our society. It is therefore equally important that the regulatory environment reflects their unique role and a sensitive to their needs. This is particularly important in relation to smaller societies.

## **Examinations of Witnesses**

### **First Examination of Witnesses – 11th October 2004**

Sandy Crombie, Chief Executive, Standard Life

### **Second Examination of Witnesses – 26th October 2004**

Steve Huxham, Spokesperson, Investors Association  
Adrian Coles, Director General, Building Societies Association  
Malcolm Berryman, Association of Friendly Societies  
Steve Burnett, Chief Executive, Royal Liver Assurance

### **Third Examination of Witnesses – 9th November 2004**

Mike Yardley, Chief Executive, Royal London  
Graham Berville, Chief Executive, Police Mutual  
Mick McAteer, Principal Policy Adviser, Which?  
Ian Geden, Chair, Association of Mutual Insurers  
Shaun Tarbuck, Chief Executive, Association of Mutual Insurers

## **Written evidence**

Ernst & Young “ Returning to Radicalism – Mutuality in the 21st Century” November 2002

Nationwide submission to the All Party Parliamentary Group on Building Societies and Financial Mutuals

Abbey plc submission to the All Party Parliamentary Group on Building Societies and Financial Mutuals

Treasury Select Committee – Ninth Special Report, Demutualisation 1999

“Mutuals and Their Communities”, Mutuo, December 2004

The Industrial and Provident Societies Bill – House of Commons Research Paper 02/08 23  
January 2002

The Co-operatives and Community Benefit Societies Bill – House of Commons Research Paper  
03/08 29 January 2003

Welfare and the Consumer Society, New Opportunities for the Third Way – Professor Nigel Waite,  
September 2001

Building Societies Association – Key Messages – November 2004

*Improving Financial Inclusion – The Hidden Story of How Building Societies Serve the Financially Excluded* – Dr Karl Dayson, November 2004

Mutual Life Offices Review - Submission by the Building Societies Members Association

'How mergers squeeze savers' Which?, February 1996

'Danger of building society conversions' Which? Consumer Policy Review, August 1996

