THE CASE FOR CORPORATE DIVERSITY WITHIN THE FINANCIAL SERVICES SECTOR

Following the May 2010 election, the incoming Government's Coalition Agreement included a commitment to diversity in financial services:

> *We want the banking system to serve business, not the other way round. We will bring forward detailed proposals to foster diversity in financial services, promote mutuals and create a more competitive banking industry. (The Coalition: our plan for Government, 2010, p. 9)*

"...a stronger mutual sector would promote effective competition and mitigate systemic risk."

In response to this commitment, Mutuo commissioned a Report, 'Promoting Corporate Diversity in the Financial Services Sector' from the Oxford Centre For Mutual And Employee-Owned Business. The Report seeks to help Government by setting out a detailed and realistic strategy for achieving diversity in financial services, thereby enhancing financial stability and widening consumer choice.

Building societies, friendly societies, mutual insurers, co-operatives and credit unions all have long traditions of providing an alternative to shareholder owned businesses and provide choice and competition that is valued both by consumers and by the Government.

The report argues that a stronger mutual sector would promote effective competition and mitigate systemic risk. It urges the Government not to return to the 'business as usual model' for the financial services sector, which proved such a risk to the economy.

The report produces a raft of recommendations to help the Government to support its Coalition Agreement commitment to foster diversity in financial services and promote mutuals.

Why diversity matters

The UK financial services sector has for more than a decade been dominated by the mono-culture of the shareholder owned plc, the purpose of which is to maximise financial returns to shareholders. Moreover, this mono-culture is very concentrated on London/the city.

The ever greater risks taken by the banks to drive up financial returns for shareholders eventually culminated in the global credit crunch of 2007-2008. Given the financial, economic and social costs of that credit crunch and subsequent recession, a key priority is to put measures in place that will prevent such a reoccurrence in the future.

Building Societies Association

Kellogg College

afm association of financial mutuals

Diversity of ownership and business models

A major contribution to ensuring financial stability is to create a more diverse financial services sector. Diversity of ownership and business models promotes systemic stability and is also good for customers because of the resulting increased competition and choice, quality of service and fairness.

Corporate diversity promotes competition and drives further innovation and performance improvements. There is strong evidence from the UK and globally that a more diverse financial services sector will help to deliver significant benefits in these areas.

Why the Government should value mutuals

The Government has rightly identified that the UK's financial services market requires greater diversity and this is an ideal opportunity to promote the mutual model.

The priority of a shareholder owned business is to make a return to the shareholders. The focus of a mutual is on the business needs of its customers. Mutuals therefore have different objectives which can contribute positively towards developing a more stable and robust financial system which is a major reason why diversity must be fostered and encouraged.

One of the features of a mutual is that it cannot easily inject external capital, and this tends to be a natural inhibitor of risk appetite. A financial services sector containing a mix of mutual organisations alongside the plcs will have a spread not only of business models but varying corporate attitudes to risk. This is a positive feature and will help to create a more stable and robust financial services sector.

A serious rebalancing of the UK's financial services sector towards mutuals, co-operatives and credit unions is required to help create stability within the system. Up until now government policy has discriminated against the smaller mutual sector as it has supported the larger banks considered 'too important to fail'.

Very little financial support has been made available to the mutual sector, which has had only limited access to the special liquidity scheme and credit guarantee scheme, whilst the FSCS has actively discriminated against the mutual sector which has always relied on funding its lending from retail savings rather than via wholesale money, unlike many banks. This has resulted in disproportionate requirements to contribute to the compensation scheme in respect of failed institutions.

Mutuals have also had to compete with state owned banks providing 100% guarantees of savings (whether implicit or explicit) and the ability of state owned institutions to offer unique savings products (such as National Savings & Investments) in a low interest rate environment where wholesale funding is less available.

More diversity and competition, on a level playing field, will help to reinvigorate the wider financial services sector and will lead to a better deal for consumers.

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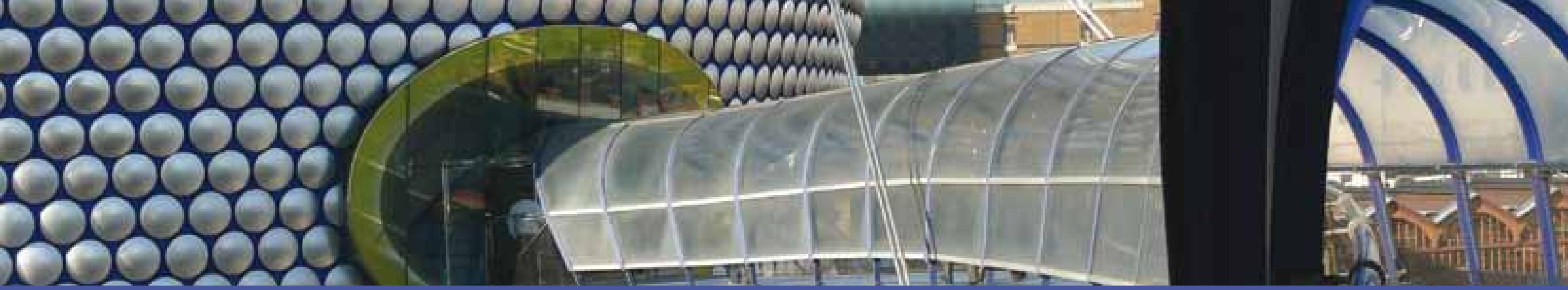

Looking to the future

Too often, mutuals have been an afterthought with UK policy makers and financial regulators. Given the Coalition commitment, there is now an opportunity to formalise a relationship between policy makers and the mutual sector that could avoid costly mistakes and create a diverse financial services sector.

The Treasury White Paper talks about removing barriers to entry as part of maintaining diversity (HM Treasury, 2010). We are calling on the Government to take action to remove the barriers to diversity by changing the approach of both financial regulators and policy makers to working with mutuals.

Whilst it is encouraging that the Government has identified a growing role for mutuals, the experience in financial services is that top-line messages need to be supported by effective legislation and regulation.

Regulating for diversity – Actions for the new Financial Regulators

1. A responsibility to promote corporate diversity

Within the new regulatory framework, we believe it is essential there is an explicit requirement on the new regulators to promote diversity of ownership given direction towards fostering diversity and promoting mutuals.

2. A strengthened in-house team to work with mutuals

This should be accompanied by an appointed new senior post of Head of Mutual Policy within each of the regulatory bodies.

3. A proportionate approach to regulation

Regulation needs to be proportionate. Regulation and the demands it makes represent a powerful competitive advantage for large incumbent players because they can more easily absorb regulatory cost, and we believe a more equitable solution for smaller players must be considered.

4. Shared responsibility for Mutuals between the PRA & CPMA

The White Paper makes it clear that the new Consumer Protection Markets Authority is responsible for the 'promoting mutuals and fostering diversity' agenda: this needs to be written into new Prudential Regulatory Authority objectives as well.

There should be a commitment for the PRA and the CPMA to take due account of diverse business structures;

5. The Bank of England

We believe that the Bank should develop policies that encourage diversity in financial services, and that it should not evaluate mutual performance against plc measurements.

The strategic policy vision – Actions for HM Treasury

1 A Minister for Mutuals

We are calling for the appointment of a Minister for Mutuals (like the Minister for the City). The Minister would be supported by a suitably qualified team of experienced officials to work across Government departments.

A priority for the Minister would be to set out the strategic vision for delivering on the Coalition Agreement's commitment to fostering diversity

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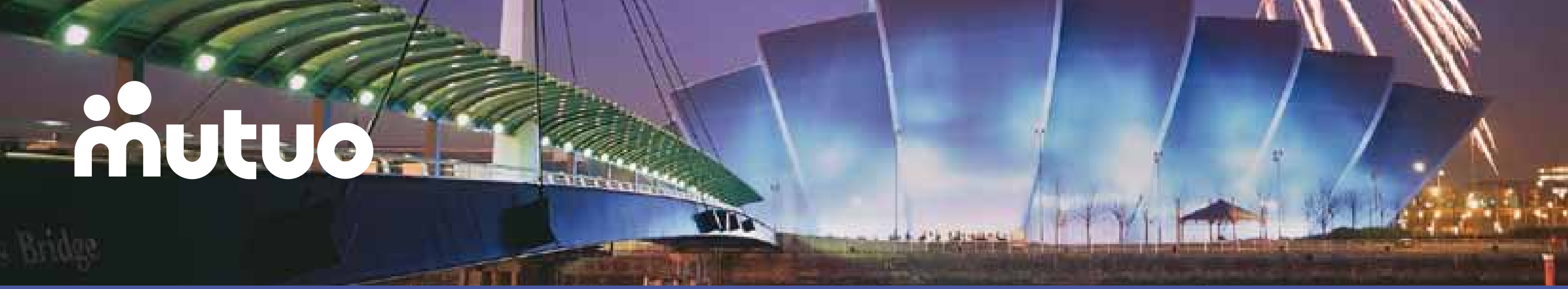

and promoting mutuals and would ensure equal treatment for the mutual and proprietary models as a principle of public policy which should set the agenda for regulators.

2. Financial Services Compensation Scheme (FSCS)

The review of the funding of the FSCS is not due to deliver any changes until 2012/13 – a fairly lengthy review period. It is important that the authorities recognise the issues at stake for retail funded mutuals in the review, especially as the latest EU directive envisages the establishment of a standing fund by deposit protection schemes throughout Europe over the next 10 years.

3. Fair Competition

The Bank of England's June 2010 Financial Stability Report stated that 'the larger UK banks expanded much more rapidly than smaller institutions in the run up to the crisis and have received disproportionate taxpayer support during this crisis.' (Bank of England, 2010).

Banks now dominate the retail savings and mortgage markets. Mutuals are keen to discuss with Government how best to restrict such activities of taxpayer funded institutions so they do not affect adversely the activities of those institutions that did not receive taxpayer support.

4. Updating legislation for mutuals

The mutual sector suffers from legislation that, in some respects, has failed to keep pace with company law. In order to compete on equal terms with proprietary organisations, mutuals will require legislation – such as the Friendly Societies Act and the Building Societies Act – to be updated.

5. New investment options for mutual insurers

Mutual insurers hold significant volumes of capital: unlike building societies this money is not lent to borrowers, but is instead invested – in equities, property, or gilts. It may be possible to develop a wider range of options for investment that are more efficient in the real economy and to support government initiatives – such as creating investment vehicles to invest in infrastructure projects, or in providing the seed capital that would enable the creation of new mutuals.

Conclusion

There are many examples of the positive role that mutuals can and do play, but these impacts could be greatly enhanced given the right environment and political goodwill. The benefits of creating a more diversified financial services sector include greater stability, more accountability to consumers, increased competion and better access to financial services.

Research indicates that mutuality appeals to consumers, but mutual organisations will need Government commitment and action in order to ensure greater diversity in UK financial services.

We believe there is a window of opportunity to create a diverse and fairly regulated UK financial services sector that will encourage competition and customer service offerings.

We look forward to taking these issues forward with the Government, the Treasury Select Committee, the Independent Commission on Banking, and the Office of Fair Trading.

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