

## Democracy and efficiency: the strengths and weaknesses of one member one vote

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The BSA makes much of the benefits of mutuality in operating solely in the interests of building society members, who are also their customers, without the need to remunerate external shareholders. Critics argue that without the discipline exerted by external shareholders building society boards are not held adequately to account and tend to operate sub-optimally. In this article we consider the merits of these competing views.

Building society law requires societies to operate on a one-member one-vote basis<sup>1</sup>. All members with more than £100 of cash savings to their name and all borrowing members with loans of £100 or more have the right to receive information, annually, on the operation of their society, including a summary financial statement. Members have the right to vote at annual and special general meetings on matters such as the composition of the board and on any resolutions put forward for debate. They also have the right to propose resolutions at general meetings, and to nominate prospective directors for election. The BSA guide - *Your Rights as a Member of a Building Society* - provides further information<sup>2</sup>

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<sup>1</sup> The Building Societies Act 1986

<sup>2</sup> <https://www.bsa.org.uk/information/consumer-factsheets/general/your-rights-as-a-building-society-member>

Moreover, all societies have adopted voluntarily practices that, for listed companies, are compulsory, such as subjecting their remuneration policy and practice to annual vote of their members.

Building societies currently arrange for the circulation of information, and voting, on directors' remuneration. Building society legislation requires societies to include details of directors' fees in their annual reports. However, only a relatively small proportion of members request a copy of the annual report. All building societies include information on directors' remuneration and the policy behind its determination in their summary financial statement – which goes to all members with savings, or a mortgage loan, of £100 or more. Also, encouraged by the BSA, all hold voluntarily an advisory vote on their directors' remuneration reports (as is required in the quoted sector).

The obvious strength of OMOV is that each and every member, irrespective of the size of their savings balances or mortgage loan (aside from the £100 *de minimis*), has just one vote. It is not possible for any member to buy additional influence by increasing their stake in the society. However, the strength is also a weakness, in that it is difficult for any single member to exert influence on the society and, historically, it has been difficult for individual members to combine to do so. It would be wrong to assume that will continue to be the case. Societies are increasingly using social media to communicate with their members and *vice versa*. We have yet to see social media used as a vehicle for significant member activism in building societies, but it seems inevitable, given its deployment by consumer and pressure groups in other contexts, that this will change. As such, it would seem complacent for any building society to assume otherwise. That being the case, perhaps this criticism of building society democracy – ie the difficulty of members combining to influence the society - is already out of date, or soon will be?

In the listed sector voting is, in essence, based on one share one vote, so major shareholders have the ability to wield considerable influence. However, the extent to which the listed company board is truly held to account is questionable, although merely the potential for shareholders to exert influence could well be enough to affect board behaviour. But is such influence always positive? Institutional shareholders have vested interests which may coincide with those of the plc board. There is evidence that fund managers who are themselves highly paid, are less likely to challenge excessive boardroom remuneration in PLCs. Moreover, it is well documented that focus on the needs of shareholders and equity markets encourages short-termism<sup>3</sup>.

In PLCs the market for corporate control, ie the possibility of a hostile takeover, is traditionally seen as a strong source of discipline and a driver of corporate efficiency, imposing an onus on listed firms to maximise value to shareholders by seeking to ensure the share price is reflective of the underlying value of the company. There is no direct equivalent in the building society sector, although the possibility of enforced demutualisation, (notably, in the attempted hostile takeover of Leek United Building Society in 1999) has no doubt been a driver of societies' performance as they have sought to demonstrate their value to their members. However, now that most societies, ie 37 out of 44 , have charitable assignment schemes<sup>4</sup> in place to deter 'hostile' demutualisation, the threat of takeover has likely receded as an influence on their performance.

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<sup>3</sup> See, for example, the [Kay Review of UK Equity Markets and Long-Term Decision Making](#) (2012)

<sup>4</sup> These may require new investors to sign away any 'windfall' proceeds in the event of the society demutualising or, in some cases, merging.

Demutualisation, at one level, could be seen as democracy in action - ie members voting to realise the value of their shareholding in the society. However, longer-term, there has been a heavy price to pay as all of the demutualised societies have failed to survive as independent entities. Moreover while, short-term, directors and members benefited from the realisation of value in the society, longer-term the demutualisations have been value-eroding<sup>5</sup>. The taxpayer has also lost out, in footing the bill for the nationalisation of Northern Rock and partial nationalisation of Bradford & Bingley, as well as part-funding the rescue by Santander bank of Alliance and Leicester. All three of which were demutualised building societies.

In the same way as shareholders in plcs are not involved in the day-to-day operations of their company, members of building societies are not involved in the detailed running of the society. However, in a broader sense members can have a significant input into the overall approach taken by the society. Societies deploy a range of mechanisms designed to facilitate consultation, including member consultative forums and panels and these have an impact on the way the society operates, in some cases at a detailed level, and on its approach to various policy issues. The BSA's paper *Engaging conversations*<sup>6</sup> illustrates the steps taken by building societies to promote effective engagement with their members.

In building societies, members are the source of "risk" capital for the enterprise – although much of the capital in a building society has been built up by previous, rather than current, members. However, the nature of the business run by most building societies means that the "risk" run by members of societies is extremely low. Every society has capital well above the minimum specified by the Prudential Regulatory Authority and no ordinary investor in a building society has lost any of their savings since at least 1945, and - so far as the BSA is aware - for a long time before that.

Any proposal by a building society to spend more than 15% of the capital of the organisation on an acquisition or investment outside the society's mainstream business would require approval by members in a general meeting. Accordingly, members – to the extent that they are prepared to exercise their right to vote – have a say in the investment of any significant proportion of the risk capital. The board of a mutual is responsible to members in two ways – as both customers and owners. In contemplating developing the business a board needs to bear both relationships in mind.

Deposit protection under the Financial Services Compensation Scheme (FSCS), which fully protects savings up to £85,000 arguably lessens the need for members to actively engage with their society as they know they are protected in bad times as well as good. During the financial crisis there was a noticeable increase in member engagement, no doubt prompted by media coverage of the run on Northern Rock, which occurred at a time when the coverage of the FSCS was lower and included an element of co-insurance<sup>7</sup>. Such increased engagement in times of uncertainty is rational; conversely, reduced involvement in good times is also understandable and helps explain why most members do not take advantage of opportunities to have their say.

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<sup>5</sup> See [Windfalls or Shortfalls? The true cost of demutualisation](#) – a report by the All Party Parliamentary Group for Building Societies and Financial Mutuals, (2006)

<sup>6</sup> [Engaging Conversations – member engagement at building societies](#) (BSA, 2015)

<sup>7</sup> At the time of the run on Northern Rock plc in 2008 the FSCS provided deposit protection up to £35,000 but only the first £2,000 was protected 100%. Protection for the remaining £33,000 was limited to 90%.

There is plenty of academic literature questioning the received view that shareholders typically have significant and positive influence over listed companies<sup>8</sup>. Many institutional shareholders do not vote at company annual general meetings and there is little shareholder activism at many companies. Few institutional shareholders contact the ultimate owners of the shares to determine their views on company issues. Indeed, it is not clear to whom institutional shareholders are themselves accountable. Too often in the debate between corporate governance standards in mutuals and plcs the comparison is made between perfectly functioning plcs and poorly functioning mutuals.

### **If there *is* a democratic deficit in building societies what takes its place?**

If we are to accept that OMOV does not provide sufficient challenge to the executive of building societies, ie putting to one side the potentially transformative impact of social media, where does such challenge and discipline come from? The main sources would appear to be the board (as a whole), non-executive directors (NEDs), the customers, competitive markets and the regulators.

#### **The board**

Examining the operation of boards of building societies as compared to boards of listed companies, significant differences are discernible in the setting of the board agenda, in the development of the society's strategy and in the measures used to identify what success looks like. Yorkshire Building Society (YBS) is an example of society where a good deal of thought has been applied over the last few years to these issues.

The board of YBS (both executives and non-executives) recognises that its responsibility is to the Society's members. Obligations, are of course, owed to other stakeholders including employees and customers but the primary task is to protect and develop the interest of members.

Because members, each with a single vote, are unlikely to be able to combine effectively as a pressure group, the YBS board sees them, in many ways, like the beneficiaries of a trust and that means, in turn, that the board operates in a similar way to a board of trustees, acting in the best interests of the beneficiaries, or members, most of whom they will never meet.

As such, a very important aspect of the board's role is to understand and address for the benefit of members the financial benefits that arise from the mutual model; what YBS term the "mutual leeway". This leeway arises mainly because YBS, like other building societies, has no requirement to distribute returns to shareholders by way of a dividend. So returns that might otherwise have been distributed can either be reinvested or spent for the benefit of members.

To better understand the elements of this mutual leeway YBS has identified 4 main activities:

1. Generators: business streams that deliver returns in excess of the society's sustainability requirement
2. Destroyers: business streams that deliver returns that are short of the sustainability requirement
3. Transients: these can be generators or destroyers that are not part of the long term strategy, eg legacy portfolios

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<sup>8</sup> See, for example, Corporate Governance and the Market for Corporate Control: Mutuals and PLCs Loughborough University Banking Centre and BSA (1997)

4. Recipients: these are activities measurably better than the market such as higher rate saving products or better than the market customer service.

Once each aspect of the Society's performance is located in one or other of these activities it is possible for the board to test and challenge all decisions made to better understand how the mutual leeway is being used or spent for the benefit of members.

## NEDs

All building society boards have a majority of NEDs. The capacity of non-executive directors to challenge the executive depends on their quality, skills and experience. Increasingly, societies have recruited NEDs with expertise in the areas of business in which the society operates<sup>9</sup>. Regulatory emphasis, first by FSA and then PRA, on the need for increased expertise on all banking sector boards has seen an up-skilling – with small regional building societies casting their net more widely than before in their recruitment of NEDs. And there has been a shift in the breadth and balance of skills, with increased emphasis on risk management, IT, HR, and marketing, in addition to the more traditional skills and experience such as financial services, accountancy and housing.

The need for such expertise has grown as the environment in which societies operate has become more complex, due, not least, to the introduction of new regulatory requirements. But NEDs need to have a fairly wide breadth of knowledge and not rely on the expertise of their fellow directors. Training is available to society non-executives in complex areas, and directors are able to obtain independent advice at the society's expense where necessary, as provided for in the UK Code. This can assist them in providing effective challenge to the executive. Such challenge is an important part of ensuring members' interests are represented effectively in society boardrooms. Most building societies have appointed a senior independent director (as provided for in the UK Corporate Governance Code) to serve as a conduit for those members' concerns for which the usual channels are not appropriate. In other societies, the deputy chairman typically performs this role.

Effective NED challenge does not depend on directors going into the minutiae of the detailed technical matters dealt with by the executive; rather at least some NEDs should be asking broader-based questions about the impact of complex or technical issues on the overall strategy of, and risks faced by, the business. It is important for NEDs to keep members at the heart of every board decision. They need to be constantly addressing the question "what is best for the members here?"

## Customers

While listed companies are subject to the influence of their shareholders, they are less subject to the influence of their customers than are many mutuals. It is not clear that some of the extreme branch closure programmes, excessive executive pay, and approaches to service and product provision and pricing that some banks have implemented in recent years would have occurred had the directors of these institutions been accountable to their customers in the same way as directors of building societies are. Moreover, the scandals which have repeatedly beset the banks, such as LIBOR fixing, PPI mis-selling, exchange rate manipulation, pensions mis-selling, derivative mis-selling to small businesses etc have been largely avoided by building societies. While this can be explained to some extent by building societies not being active in some of the markets concerned, there is no doubt

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<sup>9</sup> See [Building Society Governance](#) an independent report by Odgers Berndtson for the BSA (2015)

also a cultural dimension, ie that it is in the DNA of building societies to “do the right thing”. Building societies do not have a monopoly on good customer service and some banks are renowned for their high standards of service, but it does tend to be visceral for societies and flows more naturally from their ownership model.

### **Measuring the effectiveness of building societies v their competitors**

#### **Customer service**

Independent research shows that building societies consistently outscore banks on various measures of customer service. For example, a survey by YouGov in July 2017 found that while 82% of building society members said they would recommend their society to friends and family, just 69% of bank customers said the same, a difference of 12 percentage points.

There were similar differences in other aspects of customer service: 11 percentage points on trusting their provider to act in their best interests (76% v 65%); 16 percentage points on feedback being listened to and acted upon (71% v 55%); and 14 percentage points on feeling valued by their provider (69% v 54%).

#### **Margins**

The difference between the interest paid by borrowers to a financial institution and what is paid out to savers is shown by the net interest margin, which is expressed as a percentage of average assets. The narrower the margin, the better deal consumers are getting. For building societies, the average net interest margin was 1.62% in 2016, compared to 2.37% at the large banks’ retail divisions, and 3.35% at a range of so-called challenger banks. Some of this difference will reflect differences in the range of services offered, but it is also likely to indicate that customer-owned building societies are generally giving their members a good deal.

#### **Complaints handling**

The Financial Ombudsman Service (FOS) publishes data on the complaints that it receives. Building societies accounted for just 3.5% of complaints received by FOS, and the Ombudsman found against societies in 17% of these cases. In contrast, banks accounted for 64% of new complaints and the Ombudsman found against the banks, and in favour of customers, in 44% of cases.

## **Market discipline**

Building societies are influenced by market forces: they decline in size, or grow only slowly, if they do not offer the savings accounts and mortgages which the market demands. The media also has a significant influence on societies’ operating environment. A vigilant personal finance press, influential web sites and social media are key components of this. For larger societies, with listed securities, rating agencies are an additional influence. Societies are not alone in this, of course, as banks are subject to similar influences.

## **Regulation**

Building societies are highly regulated, being subject to authorisation and prudential regulation by the PRA and conduct of business regulation by the Financial Conduct Authority, as well as bespoke legislation, The Building Societies Act. The FSA, in particular, helps ensure fair treatment of

customers and would provide a backstop if societies were not anyway naturally predisposed to treat their customers fairly. Moreover, the PRA imposes restrictions on building society lending, over and above requirements for other lenders, via a supervisory statement (SS 20/15<sup>10</sup>), which imposes additional discipline on societies.

In combination, these various regulatory requirements provide a further bulwark, helping to protect the interests of building society members.

## Conclusion

The one member, one vote model of building societies has both strengths and weaknesses compared to other organisational models. The enfranchisement of building society customers, as members, sets them apart from the customers of banks. However, historically, it has been difficult for members to organise themselves in effective voting blocks. The ubiquity of social media seems likely to change that. In the meantime, boards continue to bear a heavy responsibility to ensure the best interests of members are paramount to societies' strategic and day-to-day decision-making. The board of YBS is one of many across the building society sector rising to this challenge.

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<sup>10</sup> [Supervising building societies' treasury and lending activities SS20/15 \(updated Jan 2017\)](#)