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Parliamentary Commission on Banking Standards – Call for evidence

A submission by the Building Societies Association

Introduction and summary

1. The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 47 UK building societies. Mutual lenders and deposit takers have total assets of over £375 billion and, together with their subsidiaries, hold residential mortgages of £245 billion, 20% of the total outstanding in the UK. They hold more than £250 billion of retail deposits, accounting for 22% of all such deposits in the UK. Mutual deposit takers account for 31% of cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

2. A well functioning financial system supports economic growth, efficiently allocating resources to benefit society by intermediating between savers and long-term borrowers. However, a financial system that does not operate well can lead to benefits being appropriated by those in powerful positions, to the detriment of society more widely. It seems clear that some of the largest, most complex banks benefitted from too much power and influence in the run up to, and through, the financial crisis. This has been shown by the extensive state support given to the largest banking groups in the crisis, as well as by the scandalous events that have emerged in recent months, many of which occurred prior to or through the financial crisis. However, this does not mean that there is a universal problem afflicting all organisations or individuals working in the financial services or banking sectors. The incentives and culture that developed from the organisational structures at some of these institutions led to opportunities and motives such that in some instances individuals worked to the long-run detriment of society and the organisations themselves.

3. Mutuals are owned collectively by their customers, so have very different incentives and a very different culture to shareholder-owned banks. No mutual lender or deposit taker is involved in the LIBOR setting process, they did not sell swaps to SMEs, and mutuals were not responsible for the widespread mis-selling of Payment Protection Insurance (PPI). However, mutuality does not guarantee good governance and a socially responsible culture, and there have been instances where problems have arisen at some mutuals. Even so, the primacy of the customer in mutually owned firms does mean that conflicts of interest are less prevalent than in other organisational forms, and that their organisational cultures do tend to place more importance on serving customers. Mutuals continue to work on improving their corporate governance to ensure that the businesses deliver even more benefit to members.

4. It will be extremely difficult to correct failings in corporate culture by directly regulating professional standards at firms. This is because organisational culture and ethics emerge from the deeply held values of those people working within and responding to a firm's structure, leadership and its external environment. It is by changing the structure of firms or the operating environment that the ethics might be shaped.

5. If the retail financial services sector required by society in the years ahead is characterised by lower risk, lower return operations that are focussed of the needs of households and businesses, then structural reforms that promote competition and

break the power of banks that are too big and complex to fail are likely to be beneficial. Necessary changes include;

i) Support for a diverse range of business models. This will help to make the system more robust, and also enable firms to operate to different incentives, enhancing competition.

ii) Reforms, including to governance structures, that encourage ring-fenced retail banks to operate in ways that mean that they are more easily resolved, so that they do not benefit from implicit State guarantees.

Mitigating principal-agent problems: governance at mutuals

6. An important aspect of how the financial system responded to its operating environment was because of the approach to governance in banks due to the separation of ownership and control. How the owners try to influence the behaviour of the agents they employ to run the business has a direct effect on the incentives they operate to. It has been noted that a surprising lack of attention has been given to bank governance given the considerable work on principal-agent problems that suggests that ownership structure influences risk taking (Laeven 2011).

7. Much of the theoretical work looks at the agency problems at quoted institutions, and the incentives for equity shareholders to increase short-term risks, particularly as they enjoy limited liability. They therefore would benefit from higher returns to risk taking, but their potential losses are limited. And to incentivise managers to act in accordance with shareholders' interests, managers of shareholder-owned banks have been increasingly remunerated in line with shareholder returns. However, shareholders' interests may conflict with those of a bank's customers (or indeed, those of society more widely). At publicly quoted companies, the number of votes corresponds to the number of shares a body or an individual holds. Therefore a small number of large equity holders can seek greater risk and returns at the potential expense of creditors, including depositors. Accordingly, the interests of external shareholders and customers need not be aligned.

8. Building societies and other mutual lenders and deposit takers are owned collectively by their customers. They therefore do not face the same conflict of interests between customers and owners, as these groups are one and the same. For this reason Andy Haldane, Executive Director for Financial Stability at the Bank of England has said that "mutuality may do a better job of aligning stakeholder incentives than some alternative forms of corporate governance" and cites as evidence that no demutualised building society survived the financial crisis as an independent entity due to the change in incentives at those organisations (Haldane, 2009).

9. Mutuals' governance is based on the principle of one member, one vote, irrespective of the size of investment or borrowing. Building society members have the right to vote at the Annual General Meeting to appoint directors and approve the annual report and accounts. All building societies now also voluntarily hold an advisory vote on directors' remuneration. Members also have the right to nominate candidates and to stand for election as directors themselves. Therefore, building society members have a much greater degree of influence and control over the institution than do customers of banks. It is sometimes argued that the wide dispersion of building society ownership means that control of management is weak

as it is difficult for members to build a consensus, but the failures of many quoted banks shows that active engagement of owners is a universal challenge.

10. Mutuals try to engage their members to reduce the principal-agent problems they face. They have developed various methods to enable more of their members to participate in how the institution is run, and for those that do, an opportunity to do so in a deeper and more meaningful way. A study by the BSA found examples of actions building societies are taking to engage their members in more effective relationships and to garner their feedback, including:

- Meet the director sessions – where non-executive and executive directors go to meet members around the society's operating area to answer questions and inform members of how their society is performing. These are separate to the AGM.
- Member panels – where members can apply to be appointed to a panel or committee. Panels discuss topics including product development and marketing but also operations and giving their opinions on strategic decisions. Some also have access to some society board papers, and direct access to members of senior management within the society.
- Member questionnaires and surveys – on levels of customer service and satisfaction, but also other feedback. Many societies have procedures so that member feedback is brought to the attention of the board and senior management.
- Encouraging voting at the Annual General Meeting - via online voting, a 'quick vote' option, charitable donations for each vote cast.
  (BSA 2010)

11. Recognition has increased among mutuals that they benefit from having engaged members, with the Chief Executive or Chairman ultimately responsible for engaging members at most societies.

12. The UK Corporate Governance Code, including the recommendations from the Walker Review, applies to publicly quoted firms. However, with the help of the BSA, building societies have voluntarily taken on the provisions in the Code, insofar as these do not conflict with mutual ownership.

13. Corporate governance at building societies and other mutuals is not perfect, and all continue to work on improving their corporate governance processes, supported by the BSA. For example, many building societies have instigated reviews of board effectiveness to help them improve the skills and processes the board uses to oversee the business.

The effect of mutual ownership on culture

14. Being owned by customers rather than external shareholders affects not just the potential agency problems an institution faces. It has a fundamental affect on the culture and ethics of the firm, which emerge from the ongoing interaction between the operating environment and the people within the business; how they communicate and behave, the values they hold and how they identify with the organisation and its heritage.

15. As a consequence of their ownership structure, the culture at mutual organisations is very different to that at shareholder-owned banks. Employees at mutuals know that when they serve a customer they are serving one of the owners of the business. And though mutuals do have to operate efficiently and make sufficient profits to build capital and to invest in future operations, they do not have to maximise profits to increase returns to shareholders. The economist John Kay has previously noted that "the special value of mutuality rests in its capacity to establish and sustain

relational contract structures. These are exemplified in the most successful mutual organisations which have built a culture and an ethos among their employees and their customers, which even the best of plc structures find difficult to emulate." (Kay, 1991). Such long-term customer relationships are well suited to mortgage lending, where bespoke, customer specific information is helpful to ensure loans are made on a prudent basis, and to savers seeking low-risk savings options.

16. And many mutuals have a long heritage, often with a deep-rooted social perspective, as they were originally established to open up opportunities for home ownership to previously excluded groups in their communities. This need has changed somewhat, but this prestige still bears on the ethics and culture at mutual institutions. Many mutuals retain a relatively simple focus of helping their customers to save and to buy their home, and some have explicit ethical charters linked to the purposes for which they were originally established.

17. Another factor that feeds into the organisational culture at mutuals is one of a long-term focus. This flows from the ownership structure as it is more difficult for mutuals to raise external capital than it is for publicly quoted firms. Mutuals rely on retained profits, as options such as rights issues are not available to them. Mutually owned firms tend to hold more capital (the average Core Tier 1 ratio across the largest mutuals was 12.2% in 2011/12, far above the 7% under Basel III requirements). In addition, members who have savings accounts with mutuals (outnumbering borrowing members by approximately eight to one) would not benefit from any upside to greater risk-taking, but would suffer the downside consequences. They therefore tend to have a very risk-averse outlook. Mutuals therefore follow more prudent strategies than banks, as indicated by the lower level of arrears on their mortgage books, which run at approximately two thirds of the level across the market as a whole. Accordingly, mutuals' low risk, low return approach, focused on the needs of savers and borrowers means they are well placed to deliver the retail financial services society requires. This has been recognised recently by the Government:

> "The Government believes that building societies have an important role to play in the future of UK financial services. They have been successful in delivering a range of services to a large proportion of the UK population, to a high degree of customer satisfaction. They have stayed faithful to a relatively low risk model, and have generally come through the financial crisis in good shape. Finally, they have offered a mutually-owned alternative to UK consumers, and contributed to diversity in the financial services sector." HM Treasury 2012

18. An example from a demutualised society is instructive in how the culture differs between a business owned by customers and one owned by shareholders. In 1997 when The Woolwich converted from a building society to a publicly quoted bank, it emphasised the corporate culture as one of its distinguishing features:

> "We believe very strongly that retaining the Woolwich's culture and values is important for ensuring that the Woolwich's high standards of customer service are maintained and for safeguarding the future of its management and employees."
> Woolwich Building Society, Transfer Document, 1997

19. However, the following year John Stewart, Woolwich Group Chief Executive, noted that the future of many senior Woolwich employees had not been safeguarded and that the culture – previously a valuable asset at the Woolwich – was no longer suitable for the quoted bank:

"Commenting on the departure of 25% of the group's senior managers during and since the conversion process, John Stewart, Group Chief Executive, said, 'Culture has been the biggest change at the Woolwich over the last year to 18 months. A building society culture is wonderful in terms of customer care, but it isn't particularly good at identifying where the value is in the business. We need a different type of person in the future.' "
Financial Times, 19 February 1998

20. The BSA would question Mr. Stewart's assertion that listening to customers is not a good way of identifying where value is in a business – his comments perhaps indicate for whom the shareholder-owned bank was trying to create value following its demutualisation.

21. The difference in culture at mutuals means that they are less likely to get involved in widespread consumer abuses. For example, Payment Protection Insurance (PPI) was not a major product for many BSA members - this is evidenced by the fact that the big banks have so far set aside around £7 billion in redress for consumers who were mis-sold PPI. Between them, BSA members have set aside around £200 million (a substantial proportion of which is to cover the administration of dealing with claims from Claims Management Companies for instances where there are no grounds as no product was ever sold). In other markets where there have been recent scandals, such as the selling of swaps to small businesses, mutuals are not active, and no BSA members were involved in the setting of LIBOR.

22. There have been isolated incidents of mis-selling by mutuals in the past, demonstrating that mutuals are still required to put controls in place to ensure that badly formed incentives do not arise that put the customer, and ultimately the institution, at risk. Mutuals' organisational form, and the long-term focus on members that it engenders, may help to reduce these incentive problems, but they do not remove them entirely. Regulatory compliance is a responsibility of mutuals' boards and senior management, part of whose role is to lead and to communicate the desired behaviours and culture. Mutuals' focus on their members' interests helps to enforce this compliance culture.

The effect of mutual ownership on consumer trust

23. Trust is imperative to banking. A breakdown in trust can stop the financial system operating effectively (Haldane 2009). Trust is a broad concept that can cover a range of different things, from whether the individual has confidence in an institution's competence (to look after their money, to deal with their transactions effectively, and so on) to whether they can rely on the institution to treat them fairly and not to take advantage of them. These are value judgements that develop gradually over time. As such, trust and confidence are generated slowly by building relationships, though they can be undermined in an instant.

24. Consumer research has consistently shown that building societies are more trusted than banks and other providers. Recent research commissioned by the BSA has shown that a greater proportion of customers of mutuals agree that they can trust their provider to look after their best interests than do customers of banks.[1]

[1] The BSA commissioned consumer research in May, prior to the scandals in the banking industry. The research was conducted by GfK NOP, who asked 2,005 UK adults between how they rated various aspects of service at their financial service provider. We then ran some of the questions again in July to see how the widely reported events had changed opinions (1,972 UK adults between 19 and 24 July 2012). The results are summarised in the chart below. Questions on some aspects were run in May only.

25. Because the research was run prior to the recent spate of scandals, some questions were re-run to see how these events have changed opinion. There is now a greater gap between mutuals and banks on many aspects of service, including in terms of what proportion of their customers consider them to be open and honest.

26. Overall, the research shows that customers of mutuals consider that their provider delivers on various aspects of service to a greater extent than do customers at banks. This includes

- being more trusted to act in their best interests (mutuals outscore banks by 17%pts in July 2012)
- being open and honest (mutuals outscore banks by 11%pts in July 2012, up from 3%pts in May 2012)
- feels their provider has high ethical standards (mutuals outscore banks by 24%pts in July 2012)
- treating customers fairly (mutuals outscore banks by 10%pts in July 2012)
- feeling valued as a customer (mutuals outscore banks by 22%pts in July 2012, up from 15%pts in May)
- feeling their money is safe (mutuals outscore banks by 16%pts in July, up from 7% in May 2012).

27. Other research commissioned by the BSA asked consumers how their trust had changed in the few weeks in late June/early July 2012 when news of the scandals broke. 66% of consumers said their trust in banks had fallen, while 79% of consumers said their trust in building societies had stayed the same or increased[2].

28. Other research backs up these findings. For example, the Financial Services Research Forum at the Nottingham University Business School has run a Trust Index for several years. This finds that of financial service providers only building societies

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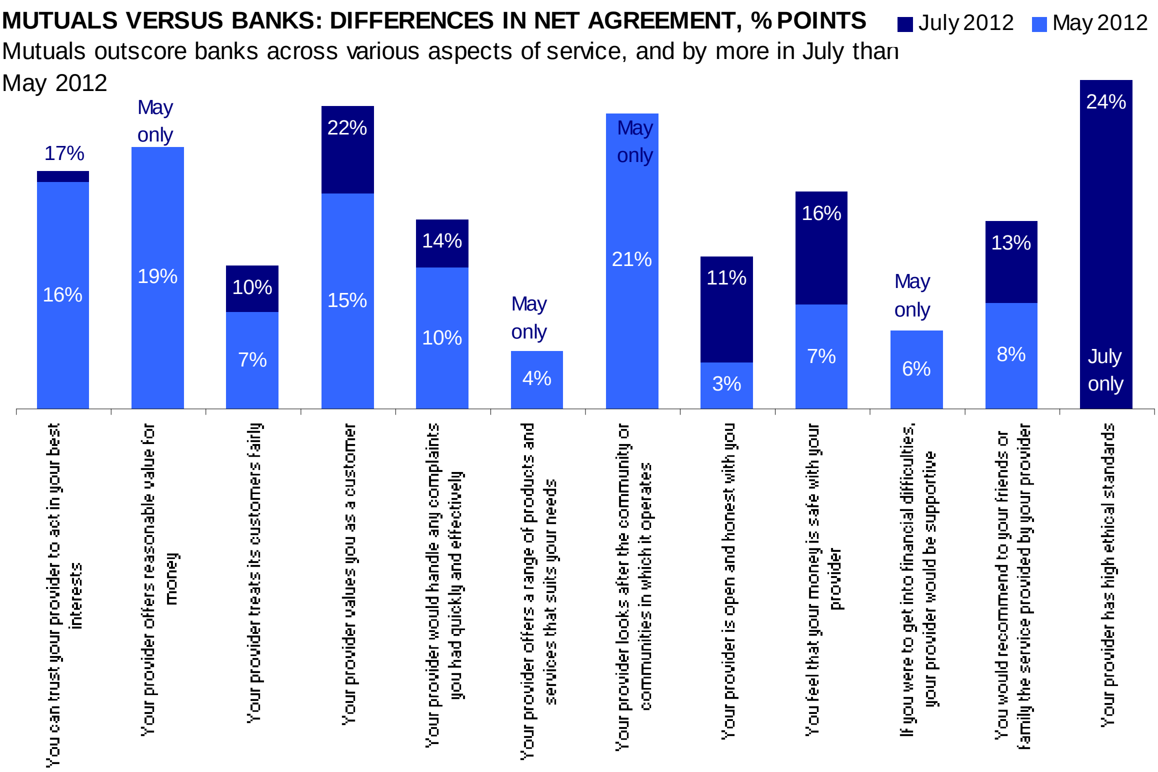
MUTUALS VERSUS BANKS: DIFFERENCES IN NET AGREEMENT, % POINTS
Mutuals outscore banks across various aspects of service, and by more in July than May 2012



[2] Survey conducted by Canadean Consumer for the BSA between 6-8 July 2012. The total sample size was 2,000 adults. The survey was carried out online. The figures have been weighted and are representative of all UK adults.

and brokers have a positive net trust score. Banks and credit card companies have persistent negative trust scores.

29. The same institution also conducts research into how fairly different types of institutions are deemed to treat their customers. The Fairness Index shows that in 2012 consumers gave building societies a score of 53.9, while banks scored just 42.9 (a score over 50 is “fair”, a score under 50 is “unfair”).

30. These results are consistent with those in previous years, so are not merely a reaction to recent events. Mutuals have been shown to satisfy a much greater proportion of their saving, borrowing and current account customers than other providers for several years, including prior to the financial crisis (BSA 2012). It is likely that the higher levels of trust and customer service are a result of mutuals’ ownership structure and leadership which mean they are focused on operating in the interests of members, rather than those of external shareholders.

Directors’ remuneration

31. All building societies hold an advisory vote at their Annual General Meeting on directors’ remuneration, though they are not required to do so by law. Since 2006, when comparable data was first collated by the BSA, on average 89% to 95% of voting members have approved building society directors’ remuneration. Over this period, all remuneration packages have been approved by at least 80% of voting members.

32. Further, analysis of the remuneration packages of building society Chief Executives suggests that they have not seen pay growth far in excess of that seen for all employees across the whole of the financial services sector, and well below that seen by FTSE 100 Chief Executives.

33. Earlier this year the Secretary of State for Business, Vince Cable MP, was reported to have noted that FTSE 100 Chief Executive remuneration increased on average by over 13.6% per year from 1999 to 2010 (FT Adviser 2012). Looking at building societies that operated over this period, the average annual growth rate in Chief Executives’ total pay (basic salary, pension contributions, benefits and performance related pay) from 1999 to 2010 was 5.4% (Source: BSA analysis of annual reports and accounts). Analysis of ONS figures for average pay in the sector “Financial & Insurance Activities” from 2000 to 2010 (data not available for 1999) indicates that average annual pay growth across the sector as a whole was 5.2%, just below the figure for building society chief executives’ pay growth. In financial years ending in 2011, executive remuneration at building societies was 80% salary and 20% performance related bonuses, where performance is often assessed on range of factors, including non-financial ones such as customer satisfaction. This is testimony to the mutual ethos and robust corporate governance that have meant that excessive distributions to Chief Executives of building societies have not been widespread.

Changing culture

34. The Commission has been asked to report on proposals for legislative action before the end of the year, and on other matters as soon as possible after that. However, the BSA would recommend that the Commission guards against knee-jerk reactions to the unsavoury incidents that have been uncovered recently, as such reactions, though well intentioned, could do more damage than good. Government needs to ensure that reforms are focussed on improving the functioning of the financial system, freeing up competition, rather than increasing compliance costs that would ultimately be passed on to the users of financial services.

35. An organisation's culture emerges from the deeply held values of those people working within and responding to a firm's structure and strategy in relation to its external environment. These factors will be interdependent. It is therefore very difficult to precisely control or direct changes in culture. This is not to say that organisational culture cannot be changed, and a factor shaping this will be leadership from senior management, with a firm's leaders a strong influence on the values and beliefs within it. At mutuals, this is informed by the primary focus on creating value for saving and borrowing members.

36. A wide range of regulators and informed commentators have recognised that specific regulatory requirements are likely to enjoy limited success at changing culture[3]. As well as increasing compliance costs, regulatory rules may not alter the underlying incentives, and may be ineffective or even counterproductive. John Kay, in his review of UK equity markets and long-term decision making, noted the risks of using regulation to impose an ethos of trust:

> "There is a real danger that such a system will stimulate the very behaviour it seeks to constrain, as people come to believe that appropriate standards of behaviour are defined by rules rather than by the integrity of the participants. … When regulation imposes requirements which are directly contrary to the business interests of those who are regulated, the likely result is formal rather than substantive compliance, and a regime which will be undermined by avoidance through regulatory arbitrage. Frustration and the resulting ineffectiveness of policy then leads to further complexity.
>
> Regulation of market structure is generally preferable to regulation of market behaviour. This lesson has been learned and applied in the regulation of other industries, such as transport and utilities, but has not been sufficiently recognised in financial services. Regulation based on behavioural prescription tends to be at once extensive and intrusive, yet limited in effectiveness and vulnerable to problems of regulatory capture – a tendency to see issues through the eyes of the industry rather than its customers. All these outcomes are characteristic of the regulation of financial services and have developed in recent years." (Kay 2012)

To affect culture more fundamentally is therefore likely to need changes to the structure of organisations and markets, for example those being implemented in the Banking Reform White Paper, based on the ICB recommendations. Changing the operating environment will then change the values that result in successful performance.

Influencing corporate cultures through a more diverse and competitive market

37. The BSA believes that the Parliamentary Commission's proposals should focus on enhancing the environment and structures within which the financial system operates. This can be achieved by breaking the power of the largest banking institutions that are too large and complex to be disciplined effectively by market

[3] In his final speech before departing as Chief Executive of the FSA, Hector Sants said, "Central to good governance is a firm's culture. I have spoken a number of times on culture explaining that I do not believe a regulator should prescribe what the 'right' culture is. Rather a regulator should ensure that the right enablers are present to incentivise a culture that delivers the right outcomes." (FSA 2012)
Similarly, the Bank of England's Andrew Haldane has suggested that regulation might be insufficient to restore public trust in the financial system if financial institutions themselves are not seen to engage in 'root and branch' reform to create "a self-generated sea-change in the structure and strategy of banking," concluding that "thrift, mutuality and relationship-building… offer a tried and tested – indeed, trusted – roadmap for the period ahead." (Haldane 2009).

forces, and enabling effective competition by supporting a diverse range of financial service providers.

38. Having organisations that are too complex to be allowed to fail distorts the incentives in these firms, affecting their corporate cultures, particularly regarding their approach to risk. The subsidy that large, complex banks enjoyed as a result of the implicit Government guarantee also distorts competition. Analysis by the Bank of England found that the largest banks benefitted from subsidies of £102 billion in 2009, while building societies received benefits of about £2 billion (Bank of England 2010).

39. It is to be hoped that the implementation of the ICB's recommendations on structural reform will go some way to reducing these guarantees and correcting these distortions. Requiring ring-fenced banks to hold more capital and making them (and their parent groups) easier to resolve will also improve the discipline on management.

40. Indeed, the introduction of these reforms provides an opportunity to require governance structures in ring-fenced retail banks that support the development of cultures and incentives in these parts of banks that fit with the needs of society. Ensuring that appropriate controls are in place for ring-fenced banks, and that a strong enough internal separation between the board and operations of the ring-fenced bank and the investment bank will be essential to reforming the behaviour of the largest banking groups. Risk management at building societies was specifically highlighted by the Independent Commission on Banking in its Final Report as providing "a particularly good basis for the risk management functions of ring-fenced banks" (ICB 2011).

41. The Building Societies Act (1986, and the 1997 amendments) imposes restrictions that shape the appetite for risk in building societies, and therefore have a profound impact on their corporate cultures. These include so-called 'nature' limits which restrict the proportion of non-member funding to a maximum of 50% and a requirement that at least 75% of loans be secured on residential property. Restrictions on the powers of building societies' treasury functions prevent them from acting as a market-maker in securities, commodities or currencies. And building societies may not trade commodities or currencies. A society may use derivatives to limit its exposure to a specified list of risks only, including interest rate (and basis) risk, inflation risk and house price inflation risk. The use of such derivatives, such as interest rate swaps which underlie the provision of fixed rate loan and deposit products, helps a society to manage and hedge its own risks.

42. While the BSA supports the proposal in the Treasury discussion document *The Future of Building Societies* that building societies be allowed to offer an expanded range of simple derivative products, subject to the same safeguards as ring-fenced banks, this would not represent a change in the fundamental purpose of building societies. This would merely enable building societies to compete on an equal basis to ring-fenced banks, including any potential expansion into SME lending any mutuals may wish to make, enhancing competition in these markets.

43. No organisational or governance structure is perfect. There is therefore value in having a diverse range of firms providing financial services. With different models, firms face different incentives and therefore react to the external environment in different ways. This has benefits for financial stability as it makes the system as a whole more robust to shocks, but it also leads to more effective competition as the different business models provide competition of a qualitatively different type than is provided by just adding an additional firm with the same business model (Michie 2010). In an uncertain world, a diverse range of firms operating to varied incentives will be most able to cope and to evolve to changes, and will offer wider choice and more innovative products to consumers, to the benefit society more widely. Similarly, the Ownership Commission recently found that effective ownership across an

economy stemmed from a plurality of ownership types, as well as good stewardship and engagement (Ownership Commission 2012).

44. Diversity of provision should therefore be supported, with a range of firms in terms of size, structure and geographical focus. The commitment in the Coalition's Partnership Agreement to "bring forward detailed proposals to foster diversity in financial services, to promote mutuals and to create a more competitive banking industry" remains an important objective. The Treasury discussion document *The Future of Building Societies* should be the springboard to modernise the Building Societies Act to free building societies to compete on an equal basis with ring-fenced banks, as well as each other. Other regulatory reforms should be proportionate to the risk posed by an institution, and the varying effects of regulations on different structures should be recognised (Laeven 2011).

45. A thriving mutual sector that is able to compete on an equal basis with banks that no longer enjoy implicit Government guarantees will provide a constraint on the banking sector. This competition will be based on incentives and corporate cultures that derive from an organisational structure where consumers and their communities are the main focus. As such, increased competition from diverse providers can prevent incentives that have results detrimental to society becoming prevalent.

Conclusion

46. The financial crisis, and the recent scandals that have come to light, show that the behaviour of the largest banks in the UK needs to change. Reducing the power of too complex to fail institutions by making them easier to resolve, and opening them up to more effective competition from a diverse range of providers will shape the incentives within these organisations so that they act in a more socially appropriate way. While mutual ownership is not without governance problems, mutuals' low risk, low return approach is likely to fit better with what society demands from retail financial service providers in the future. Together with their focus on members rather than external shareholders, a focus which runs through their corporate cultures and how they serve their customers, they will provide a valuable competitive challenge to large banks.

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