BUILDING SOCIETIES ASSOCIATION

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Information

The Case for Building Societies

Over the last few years there has been an intense debate about the future of building societies. Some have taken the view that they are outmoded, anachronistic, Victorian institutions with a glorious past but little role to play in the 21st Century. Those articulating this view have noted that a significant number of large building societies have converted to plc status, becoming banks in the process.

On the other hand, there remains in the UK 66 mutual building societies that are clearly demonstrating that a focus on the consumer, a freedom from the requirement to pay dividends to shareholders, and a long term perspective can deliver significant benefits both to individual members and to the financial system as a whole.

This paper promotes the case for building societies. The first section describes the current role of societies, and includes a factual description of their size and scope, the legislation that governs their activities and the way in which they are regulated. The second section examines the advantages of the building society model for both the members of societies and for the financial system as a whole. The third section questions the reasons for conversion that have been given over the last few years. A final note concludes the paper.

The Role of Building Societies

(a) Size and Scope

Building societies are specialist providers of mortgage finance and deposit savings accounts, although in recent years a number of them have diversified into related fields. The key data describing the size of societies is shown in the table below.

Table 1: Building Societies: Key Data, end 2000

Assets	£165 billion
Branches	2,100
Staff	34,000
Investors	15 million
Borrowers	2.5 million

Note: All statistics exclude Bradford & Bingley Building Society, which converted to plc status on 4 December 2000.

Building societies currently account for about 20% of all outstanding residential mortgages in the United Kingdom and about 18% of all personal sector deposits held by building societies, banks and National Savings. A number of societies also offer related products such as offshore deposit accounts, cheque accounts, credit cards, stockbroking services and estate agency; most also sell a range of insurance products. One society owns its own life insurance subsidiary, but most of the remainder sell or arrange the provision of products ‘manufactured’ by life insurers, acting as independent financial advisers, tied agents or introducers under the polarisation provisions introduced under the Financial Services Act 1986. Societies also typically sell house and contents insurance to home buyers. Outside the personal sector, societies are active in lending to housing associations and a number also have small commercial loan portfolios; on the other side of the balance sheet they raise about 20% of their funds from the wholesale money markets, rather than individual investors.

(b) Legislation

Building societies operate under their own specific legislation, currently the Building Societies Act 1986 - as amended, especially by the Building Societies Act 1997. Until 1986 building societies operated under legislation little changed from an Act of 1874, which provided that they raised funds from investing members and used these funds to provide mortgage loans to borrowing members. Any other type of activity was prohibited. These restrictions became increasingly inappropriate during the deregulatory years of the 1980s. Accordingly, the Building Societies Act 1986 allowed societies to offer a wider range of specified services connected with personal finance, housing and housing finance. That Act set limits on the amount of wholesale funding societies could raise and on the amount of non-residential mortgage business they could undertake. It also introduced the concept of conversion to plc status, an option not previously open to societies.

During the 1990s, it became increasingly clear that the prescriptive rules contained in the 1986 Act were ill-suited to cope with the continuing rapid changes in the financial services market. After consultation, the Building Societies Act 1997 was introduced. This was not a free standing piece of legislation but made substantial amendments to the 1986 Act. The key points are -

> (a) Building societies must hold at least 75% of their business assets (ie, excluding liquid assets and fixed assets) in the form of residential mortgages. The remaining 25% can be held in any type of asset provided the society can convince itself, its regulator and its members that it has the appropriate managerial and financial resources to move into other areas. The figure of 75% can be reduced to 60% through secondary legislation introduced into Parliament by the Treasury.
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> (b) Societies must raise at least 50% of their funds from members who are individuals.
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> (c) A society can undertake any activity, as long as it is not expressly prohibited by the legislation and forms part of the memorandum of powers agreed by members. This turned the previous legislation on its head; previously societies could undertake only those activities permitted by the legislation, with anything else prohibited. The prohibited areas now comprise taking positions in the derivatives, commodities and foreign exchange markets.

So far most building societies have not used their powers of diversification extensively. Approximately 95% of all lending undertaken by societies is in the form of residential mortgages, and around 75% of the funds raised are from individual members. A few societies do, however, offer a wide range of additional services.

(c) Regulation

Societies are regulated, on prudential issues, by the Financial Services Authority, a statutory body established under the Financial Services and Markets Act 2000

(d) Constitutional Provisions

Building societies are member-based institutions. Those opening an investment or mortgage account become a member of a society and have the right to receive certain information about the way the society is being run and to attend, speak at and vote at annual and special general meetings. Each member has one vote irrespective of the amount invested or borrowed. Members can propose resolutions for consideration by an AGM or SGM if they have support from a sufficient number of qualifying members. (Generally a member will qualify to propose or support the proposal of a motion if he or she has had £100 invested (or borrowed) for two or more years.)

The Building Societies Act 1997 made building societies more accountable to their members. Among the changes were the following:

(a) Borrowers were given the vote on general issues affecting the society (previously they had been able to vote only on proposals to merge or convert).

(b) Societies are required to hold polls for the election of directors of the society even if the number of vacancies is the same as the number of candidates.

(c) A proposal for significant diversification now requires the support of members (expressed at a general meeting) before it can be implemented.

Advantages of the Building Society Model - For the Member

In 1989 Abbey National became the first building society to become a plc. There were no further developments until 1994 when Cheltenham & Gloucester announced it was to become a subsidiary of Lloyds Bank, an objective achieved in 1995. Since 1994, and including C&G, nine societies have demutualised, accounting for more than two thirds of the total assets of the sector in 1994. Just two of the then largest ten societies remain mutual. The remaining societies have been under some media and member pressure to follow this trend and also demutualise. This section explains what advantages building societies offer to their members.

The key advantage of a mutual institution over its plc competitors is that a mutual does not need to pay dividends to equity shareholders. Evidence from the converted institutions’ annual reports confirms that conversion to plc status results in a significantly higher cost base. The payment of dividends has increased the total costs faced by those institutions that are now banks, but used to be building societies, by around 35% - ie management costs, plus dividends, are around 35% higher than management costs alone. There are four sets of arguments that suggest building societies, as a result of this competitive advantage, offer a better deal to their customers than do plcs.

(a) Narrower Margins

The first set of data relates to the margins under which building societies and comparable, quoted, plcs operate. The table opposite shows figures for 1999 on the net margin between interest earned on mortgage and other assets and the interest paid on savings and wholesale deposit liabilities; essentially this represents the resources required by the institution to run its business and make a profit. The figures for the building societies cover their entire business (which, as noted earlier, broadly speaking, is retail savings and residential mortgages). The figures for the banks (which tend to be a little more diversified than the building societies) cover, as far as possible, that segment of their business related to residential mortgages and retail savings. As the building society data covers their whole business (including small amounts of commercial lending, credit cards, cheque books etc, which carry higher margins) their overall margin is slightly inflated, particularly in the case of Nationwide.

Table 2: Margin Comparison for Converted Institutions and Building Societies 2001

Quoted Mortgage Banks - residential mortgage and retail savings business	%	Building Societies - society only	%
Abbey National	2.27	Britannia	0.97
Alliance & Leicester	1.74	Chelsea	1.45
Bradford & Bingley	2.34	Coventry	1.17
Halifax	2.12	Derbyshire	1.39
Northern Rock (Group)	1.30	Leeds & Holbeck	1.12
Woolwich	2.11	Nationwide	1.60
		Newcastle	1.28
		Norwich & Peterborough	1.45
		Portman	1.28
		Principality	1.06
		Skipton	1.04
		Yorkshire	0.97

Source: Individual accounts or press statements.

Furthermore there is little sign of greater efficiency at the quoted institutions. As accountants KPMG point out in *Building Societies Database 2001* (August 2001), "Increased competition in the marketplace has driven down margins in the building society sector and created greater cost efficiencies."

(b) Better Products

The second factor suggesting that there are advantages accruing to members resulting from societies' mutual status comes from the 'best buy' tables compiled by various independent commentators, and various other pieces of independent research. A selection of these is summarised below. Many other surveys have reached similar conclusions -

(a) A survey published in December 2000 by *Moneyfacts*, the UK's leading authority on mortgage and savings rates, showed that of the 35 largest lenders, 12 of the top 15 cheapest mortgages were offered by building societies. Also, a survey published at the end of 2000 by The Research Department of the largest 30 lenders found that 17 of the 20 cheapest over the previous year had been building societies.

(b) On the savings side, a *Moneyfacts* study of the performance of TESSAs over the five years to the beginning of 2001 found that 11 of the top 15 performing accounts were from building societies.

(c) A survey conducted on behalf of the BBC Radio 4 *Today* programme in the spring of 1998 asked 978 adults "If you wanted to get a mortgage, who would trust most to help you choose the best one for your circumstances?". 44% of respondents said they would trust one of the traditional building societies, only 8% said they would trust one of the newer banks that used to be a building society. The traditional high street banks scored higher than the converted building societies, with 23%.

(d) Finally, the opinion research organisation MORI undertook research in February and March 2001 of over 100 personal finance journalists - individuals working in TV, radio, national and regional newspapers and specialist magazines, who might be regarded as being best placed to judge the competing claims of proponents of conversion and mutuality. MORI found that only 3% of the journalists interviewed agreed, "the conversion and takeover of building societies will result in a better service for customers". 76% disagreed with this statement. A resounding 65% of journalists also agreed, "in the long run, customers of building societies that remain mutuals will gain more benefits than customers of building societies that convert".

Independent financial services commentators have also commented on the margin advantage which building societies enjoy. For example, in March 1999 Thompson Financial Bank Watch, a credit rating agency, found that "Mutuality is a sustainable corporate structure that does not disadvantage the credit-worthiness of an institution. The absence of external shareholders means that building societies will always have a "margin advantage" over plcs." Similarly, an analyst at the stockbroking company West L B Panmure was quoted in *Investors Chronicle* on 19 November 1999 as saying "Life is cheaper as a mutual as there's no shareholders to service and no dividends to pay."

(c) Market Share

The third piece of evidence suggesting that building societies' products are relatively attractive to customers lies in the data for market share. Building societies account for about 20% of outstanding residential mortgages. Similarly, in the market for retail deposits, building societies, with 18% of outstanding deposits at the beginning of the year, accounted for 40% of the increase in deposits during the 11 months to November 2001.

Data for the performance of the quoted converted institutions in 2000 is shown in the table below.

Table 3: Market Share of Quoted Mortgage Banks 2000

	Mortgages Outstanding %	Net '00 %	Savings Outstanding %	Net '00 £m
Halifax bank	13.0	10	13	400
Abbey National bank	8.3	8	8.3	1,200
Woolwich bank	3.1	5.5	3.1	700
Alliance & Leicester bank	2.6	0	2.6	400
Bradford & Bingley bank	2.3	0	2.3	-200
Northern Rock bank	2.0	6.5	2.0	963

Source: Individual Annual Reports

It can be seen that, generally speaking, the converted institutions failed to match their historical market shares in both the mortgage and savings markets in 2000. (Indeed, it is difficult to express the mortgage banks' savings figures for 2000 in market share terms because one of the five institutions experienced outflows.) The figures for 1997 and 1998 showed similar trends.

The tables below compare the quoted mortgage banks' aggregate performance in the mortgage and savings markets over the last two years with the aggregate performance of building societies. The first table shows statistics for the mortgage market. The first column shows that, at the end of 1997, the five quoted mortgage banks had balances outstanding approximately double those of building societies. However, in 1998 (as shown in the third column) building societies had net advances of £7.8bn, compared to a mortgage banks estimated figure of £6.3bn. This meant that the building societies accounted for 31% of the market and the mortgage banks 25%. In 1999 net advances by both sets of institutions increased (fifth column), although market shares declined, no doubt partly as a result of the entry of a number of new competitors, such as new banks distributing their products over the phone and the internet. Nevertheless, the building societies still out-lent the mortgage banks. In 2000 the mortgage banks out-lent the building societies, but still gained less than their historic market share.

Table 4: Residential Mortgage Market

	Balances Outstanding		**Net Advances**					
	end '97		**1998**		**1999**		**2000**	
	£bn	share %	£bn	share %	£bn	share %	£bn	share %
Mortgage banks	193	45	6.3	25	9.1	24	12.3	30
Building societies	98	23	7.8	31	10.6	28	9.1	22
Total	432	100	25.2	100	37.9	100	40.5	100

The next table compares the performance of the quoted mortgage banks and building societies in the personal deposit market. The first column shows that mortgage banks had personal deposits outstanding about 70% higher than the building societies at the end of 1997. Since that time, however, mortgage banks' balances have increased only slowly, rising by an estimated £1.7bn in 1998, before falling by the same amount in 1999. A slightly better performance was recorded in 2000. In contrast, building societies have shown that their savings products are much more attractive to their customers. They attracted £9.6bn (including interest credited) in 1998, £11.1bn in 1999 and nearly £12bn in 2000. Their market share has fluctuated around 30%. (The figures exclude the effect of the transfer of Birmingham Midshires (acquired by Halifax plc in April 1999) from the building society sector to the mortgage banks sector. At the end of 1998 Birmingham Midshires had retail deposits outstanding of £5.6bn.)

Table 5: Personal Deposit Market

	Balances Outstanding		**Increase in Deposit Balances**					
	end '97		**1998**		**1999**		**2000**	
	£bn	share %	£bn	share %	£bn	share %	£bn	share %
Mortgage banks	168	32	1.7	3	-1.7	-4	3.7	9
Building societies	95	18	9.6	32	11.1	28	11.9	30
Total	525	100	30.2	100	40.3	100	39.5	100

(d) Financial Inclusion

Research sponsored by the Joseph Rowntree Foundation has shown that around 7% of all households in the United Kingdom have no account relationship with any financial institution. The Government has quite rightly drawn attention to the difficulties created for these households. Lack of a money transmission account, for example, makes it difficult to use the most efficient and cheapest ways of paying utility bills; the lack of a savings account means that those on a low income do not have even the smallest buffer to cope with an adverse change in their circumstances; the lack of home insurance can mean that such households are more exposed than most to the financial effects of burglary or fire.

Building societies were created to deal with the nineteenth century equivalent of financial exclusion. They have continued in this tradition to the current day. The passbook savings account operated by building societies, but discontinued by the clearing banks many years ago, is a simple, transparent product which enables customers to be clear on their financial position. Such accounts are particularly useful for those with limited experience of personal financial management. Virtually all societies allow investors to withdraw funds (without charge) in the form of cash, or cheques payable to third parties such as utilities. Many societies find that their instant access accounts are used as a quasi-banking account with wages paid in on a weekly basis and the majority of funds withdrawn either by cheque or cash during the next few days. These accounts also offer a cheque-cashing service. Cheques can be paid into the account, and the equivalent amount of cash withdrawn, again without charge. A cheque-cashing company would typically charge 7-8% of the value of the cheque. Without the provision of the basic building society savings account, a much greater proportion of the population would be financially excluded.

A number of building societies have modernised this process by offering accounts involving some money transmission facilities including cheque books, standing orders, direct debits and plastic card access to the account. Two large societies have specifically met the requirements of the financially excluded as identified by the Rowntree research by launching accounts that offer standing orders, direct debits and a plastic card but without the possibility of the account going overdrawn.

Building societies have also shown a strong commitment to their localities. Many building societies have indicated that a number of their branches, particularly in rural and inner urban areas, remain open in order to meet member needs rather than because they generate significant profits. Indeed, for many societies the advantage to their members of their mutual status lies not only in the provision of products offering relatively attractive interest rates, but also in the provision of a higher level of service than could be offered if branches were closed and full reliance was placed on communication by telephone or through the Internet. In addition, many societies offer significant support for hundreds of local charities, sports leagues, employment initiatives and other community activities. Provision of community-based services and support would be threatened by conversion to plc status where the return to the shareholder is paramount and service to the customer secondary.

The Rowntree research shows that 84% of those financially excluded are tenants of social housing landlords - local authorities or housing associations. Societies are beginning to link with these institutions so as to introduce the benefits of specially designed savings and loan schemes offering attractive rates of interest on savings, and borrowing rates very much below those charged by door-to-door money lenders on small scale loans. One scheme is already operational in Cambridge and a further scheme is expected to be introduced in northern England shortly.

Finally, research undertaken at the University of Newcastle-upon-Tyne shows that, in recent years, continuing building societies have been more likely than the converted institutions to retain branches, and to open new ones, and also more likely to retain branches in areas of deprivation. The researchers concluded their November 1999 study (*The Contribution of British Building Societies to Financial Inclusion)* as follows -

> "There is evidence that building societies are less likely to close branches in socially deprived areas as well as evidence that building societies are opening in the same areas that converters are closing branches. These two trends taken together may suggest that building societies are plugging some of the gaps left by the closures of converters in more deprived communities."

In summary, building societies can been seen as agents of financial inclusion. Conversion and a change of focus from the customer to the shareholder necessarily involved in that process would put at risk the contribution which societies have made in this area over many years.

Advantages of the Building Society Model - For the Financial System

(a) Diversity

The presence of building societies offers advantages not only to building society members but also to the financial system as a whole. The more diversified a financial system is the more likely it is to be able to meet the stresses and strains that emerge as part of the normal business cycle and as a result of changes in consumer preferences. It is sensible not to have all of the financial sector's eggs in the plc basket. Conditions may emerge in the future - conditions that are probably not foreseeable today - that would make a monolithic plc model inappropriate. The presence of building societies preserves choice and diversity.

(b) Customer Service

Secondly, building societies serve customers because that is what they are in existence to do. Banks serve customers as a means of generating profits for shareholders. At least some institutions in the market should have the explicit objective of meeting customer, rather than shareholder, requirements. (It is notable that this requirement is reflected in building society senior management incentive schemes. The *IDS Management Pay Review*, June 1999, reports, in a survey of plc and mutual executive pay schemes, that "few of the plcs… have any measures covering customer satisfaction and only one… has both customer and employee satisfaction in its main list of annual bonus targets. Targets in all the others are all based on purely financial returns. Among the mutuals, however customer satisfaction appears regularly as a target for short-term incentives.")

(c) Competition

Thirdly, building societies provide a competitive spur to banks and other institutions. By offering competitive rates societies inhibit banks and others from widening further their own margins. The disappearance of societies will likely result in less attractive interest rates not only for building society members, but also the customers of other institutions. In the debate on charges for cash machine withdrawals it is clear that the "no charging" stance adopted by building societies has had a significant impact on the charging strategy of other institutions.

(d) Geographical Diversity

There are also advantages in geographical diversity. The majority of building societies are regional or local institutions, run from different parts of the United Kingdom, rather than from London. There is a head office of at least one building society in all twelve of the economic planning regions of the United Kingdom. These institutions can more readily take account of the special characteristics of their locality than if they are merely branches of much larger institutions quoted on, and controlled by, the international capital markets.

(e) Low Risk

A fifth factor is that building societies are systemically risk averse because they cannot replenish capital as readily as plcs. If a plc makes a substantial loss that diminishes its reserves it can ask its shareholders to provide additional capital, as at least one large bank did in the 1980s. Building societies have no such way of replacing lost capital - virtually all their capital is raised through the retention of profits - and are therefore far less likely to lose it in the first place. This is reflected in the fact that no investor has lost money invested in a building society since at least 1945.

(f) Commitment to Mortgages and Savings

Finally, it is helpful for the country to have institutions that are obliged to offer deposit and mortgage accounts to members and will therefore always be in these key markets. Although it is fashionable to regard the housing market as a market like any other, it must be recognised that the provision of a roof over people's heads is fundamental to any other contribution that they are likely to be able to make to the life of the country. There is a case for special arrangements to enhance the position of those institutions that are specifically required to finance the provision of shelter.

(g) Concluding Note

It has been suggested that newcomers to the banking market such as supermarkets, insurance companies, internet-only start-ups and leisure brands will result in the maintenance of competitive conditions even if building societies disappear. However, one distinguishing feature of all of these sets of institutions is that they have shareholders seeking a return on their investment. The April 1999 edition of the Consumers' Association magazine *Which*? reported that "despite new entrants, such as supermarkets, competition in the savings and mortgage markets will suffer from the elimination of the remaining major building societies. This, in turn, is likely to mean a worse deal for savers and borrowers." There is a limit to the extent to which shareholders of new entrants to the market will be willing to subsidise loss-making mortgage and savings deals.

David Llewellyn, Professor of Money and Banking at the University of Loughborough, put (in his address to the BSA annual conference in 1996) the systemic case thus: "There is a major public policy interest in sustaining a competitive market environment through different organisational forms because firms with the same form tend to behave in a similar manner. Choice and variety is an ingredient of consumer welfare." Systemic arguments are difficult for individual members to appreciate when considering how to vote on any conversion proposal, especially when the counter-arguments are underpinned by a large financial inducement. Matters relating to the financial system are properly a matter for Government and, in the view of the BSA, are the reason for implementing changes in the nature of the legislative intervention in the conversion process.

Reasons for Conversion?

It is up to the institutions that decided to convert to make their case. Nevertheless, it is now clear that some of the reasons put forward at the time of conversion have not been sustained. Among the arguments that have been put forward are -

(a) The need for increased access to capital. In fact many of the converted institutions have returned capital to shareholders.

(b) Increased accountability. It has been suggested that plcs are more accountable to their shareholders than mutuals are to their members. However, recent events - the votes at Nationwide and Leek United building societies, for example - have shown that building societies are very accountable to their members. The essence of the plc accountability argument is that shareholder pressure forces institutions to be more efficient. Yet, as noted earlier, the institutions that have converted tend to have much wider margins than the continuing building societies. In addition, institutions that used to be building societies are, generally, prevented from being taken over for five years. This represents the removal, albeit on a temporary basis, of a key restraint exercisable by shareholders on the management of an institution.

(c) The building society legislation is too restrictive. In fact the current building society legislation, as noted earlier, allows building societies an almost unrestricted programme of diversification.

(d) Products could be enhanced. In fact the converting institutions have lost market share in key markets.

(e) Large mutuals are remote from their members. This is not sustainable. There are many examples around the world of successful large mutual institutions. For example, the mutual Rabobank in Holland is one of only two private sector banks in the world rated AAA by the credit rating agencies. Large plcs can be more remote from their individual shareholders than mutuals because plc governance is typically concentrated in the hands of a few dozen institutional shareholders based in the City of London.

Conclusion

Building societies have played a key role in the expansion of owner-occupation in the United Kingdom and in the alleviation of financial exclusion - for many years before that term was invented. The provision of safe, straightforward savings facilities and cheap mortgage finance through a readily understandable transparent system, is not a contribution to British society that should or can be overlooked. There is now no doubt that building societies offer cheap mortgages, high interest savings accounts and a presence on the high street that makes them unique in British financial services. Building societies are determined to ensure that their proud record continues well into the 21st century.