The Future of Mutuality

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The current Building Societies Act came into force less than ten years ago. Although it included provisions to allow building societies to convert from mutual to company status, we believed that such conversion would be difficult to achieve and, therefore, very rare. The Act was welcomed as being progressive and enabling societies to take on new powers and, therefore, to become more competitive. That was ten years ago. By the end of next year, in asset size, 30% of the sector will remain. But for the recession this position would probably have been reached five years ago.

It may appear that the building society industry, with a little help, has set its course on a one way journey to oblivion. It may appear that the only uncertainty is when this will occur. Realistically no new society can be formed and the rate of conversion appears to be on the increase. You may draw the conclusion from this that building societies are weak and so should disappear. You may also draw the conclusion that we are not operating in the best interests of our customers, most of whom are our members. On the contrary; many remaining mutual societies are financially very strong and are demonstrating their commitment to mutuality and the benefits this can bring to their members.

Mutuality and its benefits

I propose to examine in more detail the reasons for conversion and the reasons why mutuality is a sustainable option. But first what is mutuality in the case of building societies? You may find that some of these criteria apply equally to the Consumer Co-operative Movement. Firstly, all of a building society's members are customers. These are made up of borrowers and investors. Secondly, each member has one vote, regardless of the size of investment or mortgage. Thirdly, the principal purpose of building societies continues to be limited primarily to the raising of retail funds for the purpose of making secured loans.

The final criteria is that the share capital of a building society is fluid and shares are not generally transferable. The share capital in the case of a building society is the total value invested in shares at any time. Building societies are therefore effectively 'consumer co-operatives', mostly set up during the last century as self-help societies with open membership and a democratic voting system. Under the building societies legislation, societies must be run for the benefit of prospective as well as current members. All benefit from the built up wealth and strength of their societies.

Virtually all of these examples of mutuality apply to co-operatives. I would identify four main differences between building societies and co-operatives. Firstly there is the complex nature of ownership within the Co-operative Movement. To the outsider, there appears to be an interweaving ownership between primary, secondary and tertiary organisations which certainly, as things now stand, appear to make conversion or take-over of the larger constituents of the movement difficult, if not impossible. Secondly, the range of businesses is far wider than, and not subject to the same restrictions as, building societies. Thirdly, the make-up of boards tends to be more representative of the members, who are encouraged actively to participate. Building societies, on the other hand, generally select external directors who are, certainly in the larger societies, City based or leaders in industry. Lastly, as a result of the different types of business, returns to members can take on many different forms. Building societies generally provide benefits through attractive rates of interest.

Having outlined what mutuality is, what are the arguments in its favour? Evidence, including Consumers' Association research, shows that customers of building societies get better returns and supports the view that, in general, customers prefer dealing with building societies to banks. For example, over the last ten years all the top ten cheapest mortgage lenders have been mutual building societies. Over that period the difference in cost for a £50,000 mortgage between the cheapest lender (a mutual building society) and the dearest (a plc) was £2,943 ('What Mortgage' magazine). Bank of England figures show that bank savers lost a massive £24bn between 1986 and 1995, compared to what they would have received if they had saved with mutual building societies. The basic mortgage rate of 6.74% at the Yorkshire Building Society saves a £50,000 borrower £250 a year compared to what would be paid at the Halifax, Woolwich, Alliance and Leicester, Bristol and West and Northern Rock all of which have announced their intention to convert. Today's best buy tables are dominated by savings products from mutuals. Societies do not have to pay dividends to shareholders and are not, therefore, subject to conflicts of interest between customers and shareholders. And finally, the disciplined and risk averse approach of building societies and their regulators provides a secure home for retail customers, none of whom has lost a penny through membership of a building society.

The disappearance of the building society sector would therefore have a number of major impacts. It would undoubtedly lead to the growth of widely diversified bancassurers whose primary motivation is one of profit for shareholders. The removal of competition from the building society sector would lead to widening of margins with higher mortgage rates and potentially more limited choice of retail investment products, with banks able to turn for all their funding to the wholesale markets. Therefore 'pay back time' would arrive for all those building society members who have sold out.

Reasons for conversion and the conversion process

You may ask, therefore, why building societies are converting and how they are managing to persuade their members. Supporters of conversion argue along the following lines. Firstly, the society has outgrown its roots and sees its future as a major bank not subject to the limitations of mutuality. Secondly, conversion provides potential for wider powers and attracting new capital. In answer to these points, members of societies should ask how they achieved such positions of strength if they were so limited as building societies, and exactly what wider powers or capital they need and how this will benefit the current members. Thirdly, critics argue that, in reality, members of building societies do not use their powers. But at least they do not have any conflict with external shareholders. Fourthly, they ask why members should not release the reserves to themselves. But this is a short term view and members are naive if they think they are getting shomething for nothing. Conversion will undoubtedly affect their position as customers and those paying for conversion will ultimately look to get their money back many times over.

Fifthly, they will suggest that members who prefer mutuals can still move on; but for how much longer? Sixthly, they argue that building societies cannot take full advantage of funding from wholesale markets, and must raise a proportion of their funds from individual investors, possibly at higher cost. But we have seen what happened to the centralised lenders who grew in the late 1980s and were not subject to the same controls. Seventhly, they say customers will continue to receive the same services. But not necessarily; margins will suffer in order to pay dividends, and there is no obligation, as with building societies, to lend the bulk of their funds on retail mortgages nor to raise fund through retail investments. Lastly, they may point out that there are benefits for senior management through share options - I cannot argue with this!

I return now to the Building Societies Act of 1986. In reality, those drafting the legislation, and indeed those running building societies, felt that the requirements to convert were difficult to achieve. No-one foresaw the levels of payouts which would be offered to members to sell out. The Act puts the whole conversion process in the hands of the society's own Board; all conversions (including, I would argue, the National and Provincial) have been instigated by the actions of Boards of societies. The Act required 20% of savers to vote on a conversion with 75% in favour, and with even more stringent rules for a takeover. It also required a borrowers vote and included the 'two year rule' which it was believed meant that no payout could be made to members of under two years' standing. It has since been shown that this seemingly difficult process was in fact easily achievable. The Abbey National won a crucial court case which rendered the two year rule useless and meant that new members could share in the distribution where this was in shares as opposed to cash. The previous 5% vote from annual general meetings increased to over 60%. The directors, therefore, saw the benefits and the opportunity to persuade members through a one-off payout. One of the lessons to be learnt is undoubtedly that, in introducing any new legislation or regulations, organisations need to be alert and fully aware of the wider implications.

The British government has made clear its pleasure at the impact of money being released into the hands of members to increase the 'feel good factor' and the buying power of customers. In reviewing the new legislation, the government is making sounds in support of building societies but not showing this in any meaningful way. It is not prepared to reaffirm the two year rule and so remove the potential for bribes and the key influence of the 'greed factor'. The government stance has been very much on the lines that societies and their members in choosing conversion are getting what they want. Therefore, what is the problem? Members have always voted in favour of conversion. They have, however, been bribed and persuaded by self-interested management. Payouts have been heavily skewed in favour of small investors as a result of the one member one vote principle. In the case of a £100 member, it is perhaps understandable that they should accept £500 or more in return for their vote. But even for such members this is not necessarily in their best interests. This generation is taking the wealth built up by previous generations and denying both itself and future generations the benefits of mutuality. We believe that a reduced margin producing lower interest rates for borrowers of at least 0.5% is sustainable by building societies. Currently the Yorkshire's standard rate is 6.74% against the Halifax rate of 7.25%. Taking an average mortgage of about £50,000 this produces an annual benefit of £250 set against a possible one-off payment to that borrower of £500 (and borrowers do not necessarily benefit at all on transfer).

So what will happen to converting societies? Some are already being swallowed up within big banks. Others are planning to go it alone. I have no doubt that societies like the Halifax will succeed. The position of smaller societies is in considerably more doubt and I would envisage many of these ultimately being taken over by banks, insurance companies or other large conglomerates. Indeed, I would envisage converting societies such as the Northern Rock and Woolwich being targeted by hostile predators ahead of the remaining mutuals.

The future for building societies

What about the future for those building societies that remain?

We see tremendous competitive advantages from mutuality for our members. I have referred to the ability to operate on narrower margins so that our customer-members take the full benefit from our products without having to reward external shareholders. We will continue to focus in two key markets for which there will always be a demand. Societies are stable and secure organisations who have built up their current position of strength over many years. Competitively, therefore, things could not be better for those societies remaining. Having said this, we are aware of the threat of hostile approaches and the influence of greed; ironically, both of these demonstrate the perceived strength of building societies. But how do we resist these forces?

Firstly, it is crucial to appreciate that mutuality will not in itself guarantee success. Mutuality is only sustainable if it delivers the products and services members want at the right price so that members can see clearly ongoing and tangible benefits. Secondly, societies must strive to create a 'virtuous circle' of mutuality with attractive products producing higher growth, resulting in lower management expense ratios, thereby enabling them to produce more attractive products, and so on. Cost efficiency takes on more emphasis than profitability and, in this respect, cost growth must be below asset growth. Thirdly, societies must have in place sturdy defence mechanisms. In this respect, the Yorkshire's first line of defence is its clear mutuality agenda with benefits for members and clear accountability to them. A full understanding of the fine detail of the conversion process and of the influences on decision-making is crucial. Societies should continually test out their defences and arguments internally and through external advisors.

We are currently reviewing legislation and probably the key aim of societies is to improve the protection measures. We are therefore lobbying for restrictions on the proportion which can be paid to individuals to remove the potential for bribes and encourage members to take a more balanced view of short and long term benefits. We are also looking to strengthen the two year rule and to give statutary force to the view that Boards of Directors should consider the wider interests of all stakeholders, in other words, not just current members but prospective members, staff and communities served by societies. This would reduce pressure from some members (notably the speculators or 'carpet-baggers' as they are now popularly known) who suggest that Boards should only have regard for the interests of current members and that conversion and therefore payouts are, by definition, in their best interests. We are also lobbying for the removal of protective measures for the benefit of converting societies in the event that such societies themselves make hostile approaches.

It is important to remember, however, that the biggest threats are from within, in particular from other converting societies and internal Boards and management. In short, mutuality is only justifiable if it is beneficial and sustainable, but its benefits are irrelevant if its management does not want it. The intention behind some of these changes in legislation for which we are lobbying is therefore to reduce the ability of management to influence unreasonably the decisions of members. Are we postponing the inevitable? I believe that those societies that choose to remain will grow from strength to strength and that managements and members will benefit from the strong competitive position and from carefully managed mutual agendas. The objective is that members will, therefore, come to appreciate the longer term benefits. Regrettably, unless there is a radical change in the law, there is no realistic chance of creating new societies. They will, therefore, inevitably diminish in number but we should reach a point (and may be close to it now) when the benefits start to be appreciated and the balance tips more in favour of societies.

Are there any warnings in this for the Co-operative Movement? Firstly, and most obviously, it depends what those running it want. If you wish to remain as you are, it is important that the benefits from your form of mutual ownership are seen to be delivered. Whilst it is important to be aware of all potential threats, the current structure of the Movement would appear to make any significant level of conversion virtually impossible to achieve. Just like the building society industry ten years ago? As numbers reduce, for example, through transfers of terms of engagement or through concentration in a small number of societies, the risk could increase. It is therefore crucial to understand all the implications of development, the potential impact of new legislation and regulations, and the personal agendas of those involved in the Movement. This is a crucial time for mutuality. I wonder what the originators of our movements at the beginning of the last century would make of these developments.

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This is an edited version of the talk given by Philip Ireland to the Society for Co-operative Studies fringe meeting of the 1996 UK Co-operative Congress.