Some Reflections on the Mutuality v Conversion Debate

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Mutuals are but one form of economic organisation amongst many. The mutual form is not an aberration from the PLC norm but is justified in its own right. There is no intrinsic superiority in the PLC form. Each form has its own advantages and disadvantages, strengths and weaknesses, which is why different organisational forms are able to exist side by side and sometimes in direct competition with each other. If one form was obviously superior the other would not have survived. Thus, the debate is not, or should not be, about the inherent superiority of one form over the other. There is a powerful case for diversity in organisational forms in the financial system.

However, regulation may impede a particular organisational form by, for instance, limiting its activities or inhibiting its ability to adjust to changing circumstances. It is questionable whether an Act of Parliament is an appropriate mechanism for defining powers of financial institutions in a situation where market and competitive conditions are subject to radical change, and most especially when issues of competitive neutrality in regulation are considered. In particular, regulation should have been changed some time ago (as some argued at the time) to allow for mutual banks.

It follows that there is no single correct form of economic organisation and neither is there any presumption that the PLC form should predominate in finance. This is shown in many countries where mutuals, co-operatives, PLCs exist together. In fact, there is considerable merit in having a financial system with a mixed form of corporate structure. It is, therefore, a distortion in the public debate for some sections of the press, and one journal in particular, to refer to the "die hards" of mutuality as if it was an historic form that was only a relic of the past rather than one of many viable forms of economic organisation.

Mutuality is not a flawed concept: in some senses it is a natural form in some areas of finance most especially where long-term

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relationships are involved. It is not, as sometimes alleged, a flawed concept for large organisations: size is largely irrelevant.

The mutual is one of several forms of economic firm. Firms of any kind exist as a means of organising economic activity and adding value in the economic system. As such, they have a command over economic resources (inputs) and in various ways transform these inputs into goods and services valued by the consumer. A firm, in say the manufacturing sector, needs an initial input of capital before it can proceed: initially this capital must be supplied externally. This is because the firm's suppliers and customers are not its owners. The firm needs financial resources to buy the inputs that are needed in the manufacturing process. However, there are two fundamental differences between firms in, say the manufacturing sector of the economy and those providing financial intermediation services - financial intermediaries:

(i) one of the major inputs of the financial intermediary is money which is the same commodity that companies require as capital;

(ii) in the case of the financial intermediary, its customers provide money and stand at both ends of the value process: customers provide the basic input (money) but also demand the service being supplied.

Put another way, the key difference is that in the mutual the customers are themselves the owners of the firm whereas there is a separation of the two in the case of the PLC.

For these basic reasons there is no *necessity* to have a specialist supplier of capital independently of the customers. It can be argued further that, if external suppliers of capital (shareholders in the case of PLCs) are not *necessary,* having them between the two sets of customers unnecessarily increases the number of stakeholders in the firm. It also adds to the complexity of agency relationships, creates potential (and unnecessary) conflicts between customers and shareholders, and raises the cost of financial intermediation. This is because there is a class of stakeholders which needs to be remunerated but which is not *necessary* for the basic function of the firm (financial intermediation) to take place.

Porter emphasises the *value chain* in the economic process of the firm. But if, in the case of a financial intermediary (and unlike a manufacturing firm), the customer is at both ends of the chain, a *value loop* is a more appropriate description. In which case the issue arises as to what precisely an external shareholder adds to the value created by the firm, and this can be justified only to the extent that the existence of the external shareholder enhances the value added by the firm, ie raises the efficiency of the process. To repeat: the issue arises because an external shareholder (supplier of capital) is not a *necessary* part of the financial intermediation process.

It is for these reasons that the mutual is a common organisation form for the financial intermediary firm, and why it exists in many countries. In fact, it could be regarded more as the natural organisational form and the PLC could be something of an aberration. The basic advantage of the mutual firm is that it offers a unique form of financial contract to its suppliers of funds which is a mix of debt and equity. This necessarily removes the potential conflict between shareholder and customer.

The fundamental issues, therefore, are which organisational form (mutual or PLC) has the greater potential to add value, who are the various stakeholders making a claim on the value added, and how payments are made to the stakeholders. The mix of stakeholders in the mutual and PLC are largely the same (customers, employees, suppliers etc) except that, in the case of the PLC, there is a separate group of shareholders who are not the customers of the firm in the same sense as the owners of the mutual who, by definition, are the customers. The over-riding issue is whether *external* capital and *external* ownership adds to the efficiency of the firm in any fundamental way. Care is needed when making the common assumption that the additional claim of an external shareholder *necessarily* reduces the benefit of the other stakeholders because, if the total value added is enhanced in the process, all stakeholders may gain because of the increased efficiency of the firm. This is the key issue: claims on the value added may not be additive within a given total.

There are two contrasting views: First, the existence of external shareholders adds nothing to the *value loop* but simply increases costs and adds an additional claimant on the value added by the firm; Second, the existence of external shareholders increases

the efficiency of the firm because they solve agency problems more effectively and efficiently. This is an empirical question that needs to be addressed.

Philosophical issues about the "true nature" of mutuality are a diversion and are largely irrelevant: the key issue is whether mutuals do or do not add value efficiently for consumers. A more pragmatic approach in the debate would be more fruitful.

Economics of the Mutual

The fundamental economics of the mutual firm (the "margin advantage" due partly to the absence of external capital that needs to be remunerated) are favourable to building societies (and life assurance offices). If there is a "margin advantage" building societies can adopt one of two broad strategies: (1) maintain a wider margin than is necessary and build up reserves through high profits, or (2) maintain a low (but sustainable) margin and increase their market share. In practice, building societies have often adopted the former strategy: had they not, their pricing would have been difficult for banks to follow. If building societies have had "margin advantage" the question arises as to how banks have been able to compete. Four factors have contributed:

(1) building societies allowed them to compete by maintaining margins in excess of what was needed to remain in business,
(2) banks have been able to cross-subsidise their business which was in direct competition with building societies,
(3) in the early years cross-subsidies by building societies (high interest rates on large mortgages) offered an entry route for the banks who targeted the subsidising part of the business, and
(4) at times, banks have had a wholesale funding advantage.

Nevertheless, for the future, the potential "margin advantage" means that building societies as mutuals have the potential to remain a powerful competitive force in the financial system providing the sector remains large enough. However, there is a dilemma in that the required interest margin of a building society

rises as its rate of growth rises.

If building societies have a "margin advantage" this can be used to benefit customers (members) in one of two ways: *ex ante* by a lower mortgage rate and/or higher deposit rate, or *ex post* by building up reserves and enhancing the value of the ownership stake. If it is not done *ex ante* there will inevitably be pressure at some stage to release value to members *ex post.* It is ironic that, by adopting a policy of building up reserves by maintaining an excess margin, building societies simultaneously allowed banks to compete and may have undermined the long run viability of mutuality. A more cynical approach is that some societies may have adopted an excess-margin strategy simply to enhance their value for a conversion.

Mutual and PLC comparisons

Comparisons are often made between mutuals and PLC in terms of performance, accountability etc. However, such comparisons are often misguided as it is not always clear on what basis the comparison is being made. Four models can be compared: (i) the **ideal** PLC; (ii) the **ideal** mutual; (iii) the **actual** PLC, and (iv) the **actual** mutual. In other words, we need to distinguish between how institutions behave in some abstract, theoretical or ideal state, and the way they operate in practice. The ideal PLC is probably the easiest to defend theoretically in that it produces clear-cut principles of objectives, accountability and control. The ideal mutual suffers from being indeterminate: a "balancing of members' interests" is difficult to specify.

The behaviour of building societies is criticised from time to time. It is alleged that they do not always behave as mutuals should do: they have deviated from their true mutuality. Two immediate perspectives are relevant:

(1) It is not at all clear that there is (or indeed, need be) a clear objective standard to judge the true and ideal behaviour of a mutual. How should an ideal mutual in fact behave? Is there any objective standard? It is not clear that there is any absolute truth or unambiguous standard which defines "true" mutuality. This concept is something of a chimera, and perhaps not a particularly fruitful line of enquiry.

(2) If mutuals deviate from their alleged "ideal" form, the **actual** PLC model also deviates very substantially from its **ideal** in several respects:

a) accountability to shareholders does not operate perfectly or according to the text-book: many institutional shareholders are on record in arguing that, in practice, their ability to bring inefficient management to task is very limited;

b) the discipline of the capital market works very imperfectly as discussed below;

c) companies, in practice, are not motivated exclusively by the maximisation of shareholder value: they often follow a wide variety of objectives and are conscious of a multitude of different stakeholders' interests which at times may conflict with the interests of shareholders. Thus, while the **ideal** PLC may be clear (maximise shareholder value) **actual** behaviour frequently deviates from this.

To compare the **actual** behaviour of a mutual with some mythical **ideal** form of PLC is clearly invalid.

Much of the public debate is in terms of comparing (iv) with (i) or (ii) with (iii) dependent on the stance being taken. In the real world, (iii) and (iv) prevail. In practice, both forms operate imperfectly and, in the world of the second-best, no safe conclusions can be drawn regarding the superiority of one form over the other. This applies particularly in he case of accountability.

In general, and when considering consumer interests, comparing the merits of the two organisational forms is probably of second-order importance in the context of: imperfect versions of each; when both operate in a competitive environment; and when the two forms compete in the same markets. Many of the arguments on both "sides" of the debate are spurious when in practice both forms operate away from their ideal characteristics.

Agency Problems, accountability and market disciplines

In theory there is ample scope for a mutual building society to

be inefficient because of weak accountability and monitoring of its behaviour:

(1) it has a very diverse shareholding: a large number of small shareholders;
(2) there are only weak incentives for shareholders to exercise monitoring and control as the costs of doing so are prohibitive and out of all proportion to the value received by so doing (in effect, a "free-rider" argument applies);
(3) there is an absence of large shareholders who have an incentive to monitor and control; this weakens practical accountability;
(4) dissatisfied members have the easier option of simply withdrawing funds from the Society;
(5) there is no market in ownership claims;
(6) because of this, there is no take-over threat;
(7) there is an absence of performance-related value of shareholdings by the management of the Society.

There are clear potential agency costs in the mutual form deriving from weak member control. However, this must be qualified as, in practice: there is no evidence that these agency costs are in fact significant, there is no evidence that they have adversely affected efficiency and performance, equally, there are agency costs in the PLC form which are similarly not perfectly addressed by its form of accountability.

Accountability of financial institutions (and all firms) is an issue that needs to be addressed: it is an important issue. However, it applies equally to the mutual and PLC forms. If accountability and corporate governance worked perfectly in the PLC there would not have been the Cadbury and Greenberry Reports or the RSA project on the company.

Capital market discipline

It is frequently alleged that a major weakness of the mutual form for building societies (and Life Offices) is that, as there is no market in ownership, there is no scope for capital market discipline to be exercised. In principle, the market for ownership of PLCs means that economic resources end up being managed

by those firms which can do it most efficiently. This is secured through the market in the ownership of companies. In addition, the threat of take-over is allegedly a powerful discipline on management. However, there are many and serious reservations to this simple proposition:

(1) the stock market frequently adopts a very short-term time horizon;
(2) the evidence indicates that only about half the company take-overs that occur actually succeed in adding value;
(3) there will always be substantial asymmetric information problems reducing the efficiency of the market: the acquired firm always has more information about itself than the bidder;
(4) asset stripping is not an unknown motive in take-overs: a successful company can be broken up simply to serve the interests of the acquiring company;
(5) the management of companies often feels itself forced to adopt business strategies to satisfy the short-term time horizon of the market and measures to maintain the share price at all times;
(6) there is no obvious evidence that the discipline of the stock market has been a powerful force in beneficially disciplining the behaviour of banks;
(7) there is a lot of evidence that markets are not very good at equating market value of companies with fundamental value (ie rational expectations about future earnings) which means that a mis-allocation of resources can occur;
(8) take-over activity occurs in waves;
(9) there are many reasons why resources in the economy may not be allocated optimally: the "second best" argument indicates that, in such circumstances, improving (even supposing that that is the case) one part of the system does not necessarily result in a net overall improvement;
(10) in many cases sheer size offers a degree of protection against hostile bids.

Thus, heroic assumptions need to be made before we can be confident that the absence of a market in the ownership of mutuals creates a serious problem. In fact, it is only in the Anglo-Saxon world that this argument would be used at all: it is not

the norm in economic systems throughout the world most notably not in Germany and Japan. The position has been put well in a *Financial Times* leader (February 10th, 1996):

> "Since many take-overs fail to achieve adequate returns for shareholders and some fail disastrously, it would seem logical to expect the shares of an acquiring company to go to a bigger discount. The fact that they do not reflects not merely the triumph of hope over experience, nor the incantations of merchant bankers and financial PRs, but the stock market's bias for action . . . In the case of mergers, shareholders of the acquiring company must satisfy themselves that there are real potential gains to be made from the combination, with a probability of success great enough to offset the generally unfavourable outcome of such transactions".

In the final analysis it is competition, and the low exit costs of members of mutuals, that is the major discipline on the mutual. If owners are dissatisfied they are able to withdraw their shareholding and, unlike with a PLC, this also reduces the capacity and overall size of the mutual. This is by far the most powerful discipline, most especially when the mutual and PLC forms are in direct competition with each other.

A positive case for mutuality

There is a positive case for mutuality in terms of:

(1) the superior performance of the mutual building societies compared with banks in terms of deposit and mortgage interest rates, rate of return on assets and capital, and overall efficiency;
(2) systemic interests;
(3) the possible positive merit of a capital constraint. It is often argued that a weakness of the mutual form is that, as capital is generated internally, it is not possible to raise large amounts of capital at one time. In fact, there may be some virtue in this as a capital constraint can act to limit risk as managers know that capital which is lost through

risky ventures cannot easily be replaced. There are many periods in history which indicate that banks with excess capital may be tempted into hazardous activities;

(4) the absence of costs associated with a potential conflict between customer and shareholder: one less class of stakeholder;

(5) the fact that many mutuals are regionally based and focused;

(6) the absence of "short-termist" pressure of the capital market;

(7) the spread of ownership rights.

There is a powerful *systemic* interest in sustaining a strong mutual sector and therefore it is a legitimate issue for public policy. It brings:

(1) the benefits of a mixed ownership structure in the financial system;

(2) in an uncertain environment diversity has advantages as it cannot be predicted which form is best suited to particular circumstances;

(3) it enhances competition through the potential for different behaviour, and

(4) it brings different forms of corporate governance.

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 are ingredients of consumer welfare.

There is no fundamental economic *need* or presumption for building societies to convert to PLC status though many may *choose* to do so. Thus, different societies will make different decisions and both are viable. Many of the arguments put forward for the case for conversion are less than compelling: the need for more powers, the benefits of diversification beyond what is allowed as a mutual; alleged economies of scale requiring large size for institutions; questions related to capital; accountability; the superior disciplining power of the capital market, etc.

However, the constraints of Acts of Parliament can be binding

in some cases. This argues against having powers defined in Acts when the market and competitive environment are subject to change. The fact that a new Act is required fairly soon after the last, and that substantial adjustments were made within the context of the 1986 Act, testifies to this general proposition. In practice, the planned move towards a less prescriptive regime is to be welcomed though it is evidently too late for some societies. Press reports indicate that the Alliance and Leicester might have come to a different conclusion regarding plans to convert had the current draft Bill been enacted two years ago. To some extent, the regulatory regime has undermined the mutual status of building societies.

The major motives in practice for conversion are:

(1) to unlock embedded shareholder value which has arisen largely because building societies have adopted strategies which have built up excess capital;
(2) to secure an allegedly stronger position to participate in the on-going and accelerating pace of structural change in the financial system: a defensive motive. (It is the case that a PLC is more able to make large acquisitions as it is more able to raise additional capital and can issue more of its own shares);
(3) to acquire a minor addition to business powers.

However, given the "margin advantage" of mutuals, members may in practice be exchanging a short run gain (the one-off withdrawal of embedded value) at the cost of a higher cost of services in the long run. The evidence powerfully suggests that mutuals have fairly consistently offered better terms than PLCs and their overall performance has been superior. Such comparisons must, however, be made with caution given that, hitherto, comparisons have been made between banks and building societies which have different business structures. The comparison would be more valid when comparing remaining building societies with converted building societies as at the point of conversion the business structure remains the same. Nevertheless, the same superiority of performance also applies to life assurance where the comparison is more direct. In addition, the mutual has the "margin advantage" which a newly converted

building society does not have. Against this general argument must be set the benefit of dividend receipts if previous members remain as shareholders in the converted organisation. Thus, to some extent, for the member that remains a shareholder in the PLC the benefit is received *ex post* rather than *ex ante.*

A distinction is drawn between *members* and *consumers* in that there are intergeneration transfers to consider. On a conversion, the current generation of members (which may have been very recent) has a claim on the reserves effectively subscribed by past generations of members. But the withdrawal of mutuals denies future consumers of the benefits of the mutual form.

The long run dimension is important given that, in practice, conversions operate asymmetrically (only in one direction) and hence once mutuals have been converted the mutual sector is permanently smaller. The recent formation of Credit Unions offers a challenge to this general proposition.

Structural change in the financial system

The retail financial services industry will change radically over the next few years: a revolution. In this context, the key strategic issues faced by building societies (along with all financial institutions) are, in practice, more fundamental than ownership structure and organisational form. It may prove to be the case that the latter are of second-order importance in the total scheme of things. Business strategies need to be framed in the context of major structural change in the financial system generated by a combination of pressures: it is the *combination* of pressures that is powerful:

(1) there is increased competition;
(2) there are lower entry barriers into retail financial services;
(3) there is a new range of non-traditional suppliers of retail financial services;
(4) competition is operating asymmetrically: non-financial companies are able to enter financial services more easily than financial firms can diversify away from finance: Marks & Spencer sells financial services but the Alliance & Leicester does not sell men's and women's clothes;

British Petroleum has a banking licence while the Bradford & Bingley does not drill for oil!

(5) information and delivery technology is transforming the industry and the structure of the retail financial services firm;

(6) entry barriers are declining faster than exit barriers;

(7) there is excess capacity in retail financial services in four dimensions: capital, firms, infrastructure, and technology;

(8) *deconstruction* allows "cherry picking" by new competitors.

It is likely that a new structure of the financial system will emerge with much greater variety in the type of firms supplying financial services: financial conglomerates, retail financial services conglomerates, core-cluster institutions, specialist institutions, boutique suppliers, joint ventures, confederations of firms etc. *There is no single right structure for a financial services firm* and there is no presumption that the most successful will be either the largest or the most diversified. To assume the opposite is, in my view, to fundamentally misunderstand the nature of the pressures operating on the retail financial services industry.

Two major issues in bank and building society strategy relate to diversification (how far an institution should go in its diversification strategy) and size. In both areas some parts of the conventional wisdom need to be challenged.

It is a universal trend for financial institutions to diversify their range of financial services and products. In many cases, this is an entirely appropriate and viable strategy. However, equally in some cases it is not. The track record of diversification by financial institutions is not universally good: some spectacular mistakes have been made. A systematic survey of the empirical literature fails to find clear evidence that the alleged synergies which form the basis of diversification strategies are in practice powerful. There is also evidence indicating that specialised institutions are often more efficient than highly diversfied institutions. The jury is still out on these issues. What is clear is that; diversification is not invariably a successful strategy; diversification is not a suitable strategy for all institutions; specialisation can be a viable and successful strategy. In the industrial world, although there are notable exceptions, the

fashion for conglomerates has passed and in some cases previous diversifications have been abandoned. Some conglomerates (eg ICI) have been broken up. This simply cautions against the implied assumption that diversification is invariably the best strategy.

The evidence about economies of scale in financial firms is also mixed. However, there are clear economies of scale in financial intermediation *processes*. The evidence powerfully suggests that efficiency has more to do with internal organisation within the firm rather than size *per se*. The fundamental economics of the financial firm are changing to an extent that may question the notion of a fully vertically integrated firm which conducts all the processes in its business. The strategy of *deconstruction* (where component processes of a business are separated and some are out-sourced) changes the economics of the firm. It is not necessary for the firm to conduct all of the processes internally. In effect, what the author has described elsewhere (*) as *Contract Banking* involves firms as managers of contracts with internal and external suppliers of processing services. This means that if there are economies of scale in processes, a small firm can secure the advantages by sub-contracting (out-sourcing) some processes. In effect, it buys into economies of scale. Thus, a firm can secure the benefits of economies of scale in four ways: (1) by itself being big, (2) by out-sourcing some processes where the economies of sale are bigger than the firm itself, (3) through joint ventures, and (4) by forming a confederation of firms. It is along the lines of (2), (3) and (4) that small firms (building societies) will be able to maintain competitiveness.

The author has argued elsewhere (*):

> "What in practice is likely to emerge is a spectrum of different types of banks. At one end of the spectrum will be the traditional fully integrated bank which, because of the economies of scale in bank processes, will be very large. At the other end of the spectrum lies the *virtual bank*. In practice, the majority will lie within the boundaries of the two with some services being provided internally and others out-sourced. It is ultimately a question of the balance between internal and external contracts and many alternative structures are likely to emerge. The development of out-

sourcing does, however, mean that there can be a role for the small bank in a market and technology environment where many banking operations require large scale to be economic. Thus, while there may be a trend towards more consolidation in the banking industry, there will still be a place for the smaller bank though it will not have the traditional structure."

The potential for new organisational structures within the financial system (eg the potential for *contract banking* and the *virtual bank*) may bring into question some of the strategies that lie behind conversion moves. As an example, if technology is increasing the economies of scale in bank processes this does not require financial institutions to be big as, through sub-contracting, economies of scale can be bought into externally.

This may also challenge the conventional wisdom that there is no future for small building societies. In my view there is a future and in different ways from those usually given in public debate. The change in the fundamental economics of the financial firm means that we need to re-assess our thinking about what constitutes a viable financial institution. It will doubtless be different in the future than in the past: we must not underestimate how radically the economics of the financial firm is changing.

(*) Llewellyn, D.T., "Banking in the 21st Century: The Transformation of an Industry" (available from the author on request).

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