Building Societies at a Cross Roads

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A few years ago there was relatively little interest in the affairs of the various sets of UK mutual institutions from the staff of other mutuals. Thus, building societies, friendly societies, co-operatives, industrial and provident societies and mutual life insurance companies saw themselves as quite separate from each other with relatively little in common. This perception is beginning to change, largely, one fears, as a result of the de-mutualisation of some of the largest building societies and insurance companies, and the implications that this might have for other mutual and co-operative bodies. It is important, however, that the various mutual bodies come together not only as a result of their fears for the future, but also because the current situation presents a range of opportunities to emphasise the distinctiveness of mutual institutions. This paper covers the background to the decisions by a number of large building societies to de-mutualise, discusses briefly some of the factors that lead to de-mutualisation of building society type institutions abroad, but which are not present in the UK, and, most importantly, looks at what I have termed the "new mutualism" from which building societies are redefining their reason for existence. The final part of the paper discusses the opportunities which are available for greater co-operation between mutual institutions.

Trends in the housing market

In order to understand what is going on in the building society sector it is necessary to take a step back and examine trends in the housing market over the last ten years. As is well known, there was a boom in housing market prices and activity in the late 1980s, followed by a very sharp recession in the early 1990s. The housing market is now improving marginally, both in terms of activity and prices, but is extremely unlikely to return to the conditions which characterised even the mid-1980s, let alone those years towards the end of that decade.

There are a range of factors suggesting that there has been a fundamental change in the way the housing market behaves, in summary, they are as follows:

(a) Much lower rates of inflation than used to be regarded as normal. In the past high rates of inflation destroyed the value of outstanding mortgage debt, while at the same time leading to rapid increases in the value of houses purchased with that debt. Low inflation and relatively high real interest rates mean that the real costs of house purchase have increased significantly. Moreover, it is now more difficult for people to use the profit from the house that they are selling (because in many cases that profit no longer exists) in order to finance a house purchase. Transaction costs must be financed from savings, for which there are various alternative uses.

(b) Government assistance to owner occupation has been reduced. In particular the retention of the £30,000 tax relief limit, the abolition of higher rate relief, and the reduction in the standard rate of relief to 15% means that during 1996 tax relief will account for about 7% of all mortgage interest payments. In the mid-1970s the equivalent figure was 40%. In addition the government has made fundamental changes to the system of income support for unemployed mortgage holders, which make borrowers much more exposed to the impact of unemployment.

(c) Conditions in the labour market have changed significantly. There is much greater variation in levels of employment and unemployment than was the case before 1980. More short term contracts, more part time jobs, greater reliance on self employment, later entry into the jobs market and earlier retirement are all features of the new employment scene. All of these factors militate against the tradition 25 year mortgage, although their impact has been ameliorated to some extent by the significant improvements in mortgage design becoming apparent in products launched over the last two years.

(d) Demographic change. There was a one third reduction in the birth rate between the 1954 post-war peak and 1977. The corresponding shift is of a one third reduction in the number of 25 year olds 25 years later. The peak in the number of people in their mid 20s occurred in the late 1980s and the 1990s is seeing a continuing reduction in the number of first time buyers, although there is a continued rapid creation of households in other age groups as a result of divorce, immigration and a sharp

expansion in the number of very elderly people.
(e) There has been increased interest in the private rented sector, government controls on rents have, broadly speaking, been abolished, the business expansion scheme provided a short term boost, and demand for rented accommodation has been increasing, particularly among young people.

The effect of the smaller housing market

In 1996 it is likely that mortgage net advances will amount to little more than £16 billion, compared to a peak figure of £40 billion in 1988, with transactions down from 2.1 million to 1.2 million. Both figures have changed relatively little over the last two or three years. However, until recently the mortgage lending industry had in place an infrastructure that was designed to cope with the much higher levels of lending which people came to regard as normal in the 1980s. As the housing market recession continued and as the realisation grew that there would be no return to the old conditions, it was argued by many that there was a need for rationalisation in the market.

In the spring of 1994 the Cheltenham & Gloucester Building society announced that it intended to transfer its business to Lloyds Bank, with the ultimate intention, now fulfilled, of becoming the bank's specialist mortgage lending arm. Cheltenham & Gloucester was relatively underbranched but very efficient and is now able to distribute its products through the Lloyds Bank branch network, and processing of both Lloyds and C & G is centralised in Gloucester, enabling Lloyds Bank to use the capital previously tied up in mortgage processing to greater effect. Other mergers that have taken place, between the Halifax and the Leeds and the Abbey National and National and Provincial have resulted in branch closures, and arguably in economies in mortgage processing.

The impact on mutual building societies

The Cheltenham & Gloucester announcement significantly changed the environment in which building societies operate and, more particularly, merge. Members of building societies suddenly realised that their membership was worth a great deal even though they had paid nothing for it. The average payout to Cheltenham & Gloucester investors made by Lloyds Bank to effect the change of ownership, was over £2,000. It is not possible to do this in the event of two mutuals merging because large payments can be made only if the reserves of the society are, in effect, either turned into shares and traded, or purchased for cash by another institution. The management of any large building society intending to merge needs to take account of the possibility of a hostile bid from another financial institution emerging which would result, if implemented, in a significant payout to the members of the society seeking to merge. There is a least a chance that the members would reject a recommendation to merge with another society if there was a chance of an alternative corporate strategy releasing value to them. It is for this reason that since the announcement of the Cheltenham & Gloucester/Lloyds Bank proposals there have been relatively few mergers and those that have taken place have involved relatively small societies for which conversion is effectively impossible.

There has also been a significant impact on the continuing business operations of building societies. Given that membership of a building society has now been revealed to be worth a great deal, but can be acquired at zero cost merely by opening a savings account, press speculation about the identity of those building societies likely to announce conversion in the near future has resulted in long queues of people outside building society branches seeking to open accounts. Indeed, on occasion, some societies have been besieged by bounty hunters seeking something for nothing. This has drastically affected the level of service which those societies have been able to offer to their genuine and long standing members, and also forced many societies to increase the minimum sum required to open an account, thus denying savings facilities to those of modest means.

A final matter for consideration, which was not the subject of debate before the Cheltenham & Gloucester announcement, is the duties of directors. Members of boards of building societies have been forced to examine their role. Are directors of building societies trustees of the funds built up by past generations of members for the benefit of current and future members? If so, they are not morally in a position to release those funds to those who happen to be members at any single point in time. Alternatively is it the duty of the directors to look after the best and immediate interests of the current members and to return value to them in the form of a share of the reserves which, legally at least, today's members appear to own?

Advantages of the plc format

The key advantage of the plc format is that it enables the institution concerned to more readily take part in the rationalisation of the mortgage lending and financial services industries. As noted above it is now difficult for two individual building societies to merge. Perhaps even more importantly, a society that has converted to plc status can issue shares. In other words, it can print "money" in order to acquire other institutions. This key advantage is not available to mutual institutions. They have to purchase with cash that has been built up as a result of retaining profit.

The second factor is the five years' protection from takeover given to converted societies. This is a feature of the Building Societies Act 1986 and was introduced because it was felt that fledgling converted societies would need protection from takeover during their early years in the stock exchange jungle, following the protection deemed inherent in building society status. It has now become apparent, however, that building societies are somewhat less protected from hostile takeover bids than was originally believed, thus increasing the apparent attraction of the five year protection from takeover granted to newly converted societies.

There are a range of other advantages claimed for conversion. Some societies feel that they will have greater freedom to operate under the banking legislation compared to building society legislation. However, the Government is proposing new building society legislation which, if enacted, will provide much greater freedom to building societies. Some have claimed that the plc form of ownership engenders greater accountability on the part of managers to owners. In the stock market context a poorly performing plc will find its share price falling, and the management exposed to takeover bids from other individuals who think that they can do a better job. The last five years have shown that building society managements that are perceived as weak and indecisive, or who have adopted an unwise lending policy, face the same fate.

Some converting societies also argue that it is important that diversification into new and unfamiliar areas is supported by risk capital rather than the capital built up from the relatively safe savings and mortgage business. A number of mutual societies would accept this argument. Finally, it is suggested that the size of an organisation itself precludes organisation along mutual lines. This is the subject of some debate. It has clearly not persuaded the large mutual institutions in Europe (for example, Credit Agricole in France and Rabobank in the Netherlands) to give up their current status. On the other hand, some might find it difficult to discover a mutuality of interest among the ten million members of the Halifax Building Society.

Developments abroad

It is interesting to note that the key factors involved in the conversion of building societies and building society type organisations to stock status in overseas Anglo Saxon countries (notably the USA, South Africa, Australia and New Zealand) have not been a feature of the debate in the United Kingdom. There are four such factors:

(a) The desire to obtain bank status. In all of the countries mentioned, building societies and other similar organisations were regarded as second rank institutions, not as important, or as safe, as banks. A key incentive to convert to stock status was to be able to call the institution a bank, so giving the institution status and prestige. It is notable that in this country those institutions that have converted, or intend to, do not and will not use the word "bank" in the name of their organisation. It is Abbey National plc for example, rather than Abbey National Bank plc.

(b) Corruption - One of the reasons for the poor name of building societies in Australia and thrifts in the United States was a not entirely undeserved reputation for corruption, which contaminated the entire sector. No such suggestions have been made in the United Kingdom.

(c) Wider powers - The UK Government has adopted a relatively liberal attitude towards granting building societies new powers. It is likely that had this approach not been followed, the current wave of conversions would have occurred much earlier.

(d) Capital - In America especially, business conditions resulted in the decimation of the capital base of the thrift industry. In order to restore capital positions it was necessary for the thrifts to issue shares not for free, but paid for, in order to recapitalise the business. British building societies are relatively well capitalised, and again, this has not been a motivation for conversion.

Interestingly and as noted earlier, there has not been a similar wave of de-mutualisation in continental Europe. Indeed, it appears that the statutory machinery to enable conversion to take place does not exist, and there is a general prohibition in French, Dutch and German legislation on the payment of any share of the profits of a mutual organisation to its members.

New mutualism

So far this paper has identified the reasons for conversion taking place. In summary they relate to the decline in mortgage market activity, the perceived need for rationalisation in the mortgage lending sector, and the greater ease with which this can be undertaken within the plc rather than mutual format. Some might take this to be a convincing case for de-mutualisation. Why then have 70 odd societies set their face against this course of action? If the key advantage of a plc is the ability to issue shares or to print "money" in order to acquire institutions, the key advantage of mutual institutions is that they do not need to pay for their capital. The ability to issue shares comes at a heavy price - the payment of dividends. Many continuing building societies have taken the view that they are now in a position to, in effect, pay a dividend to their customers by holding their mortgage rates lower and their savings rates higher than the converting societies or the banks. The Britannia Building Society has gone down a so far unique route, offering its members a share of the profits made by the organisation, that share being dependent on the nature and extent of each member's relationship with the society.

It might be asked why it took societies so long to wake up to the crucial advantage of their corporate status. The answer is that the early 1990s were characterised by a rapid growth in arrears, and most notably repossessions, on which all mortgage lenders, including building societies, made significant losses. Homes that were repossessed could not be sold so as to cover the outstanding mortgage debt, and the reduction in house prices was such that even the mortgage indemnity payouts from insurance companies did not cover the losses. During the first half of the 1990s both building societies and banks were forced to repair the damage to their balance sheets caused by the recession. Now that that repair job is complete, ways of returning value to members can be examined and implemented.

The second element of the new mutualism is unrestricted powers for building societies. Until the passage of the Building Societies Act 1986, building societies were effectively governed by legislation that was passed in 1874 (although various 20th century acts amended this very marginally). The 1986 Act enabled societies to diversify into a wide range of areas related to savings and mortgages, such as house building, estate agency, credit cards, cheque books, insurance broking and insurance underwriting. However, building societies were still left at a disadvantage compared to other financial institutions in that the legislation was very prescriptive. Building societies could only enter those markets, and could only undertake business in a manner prescribed by the legislation. it remained illegal for a building society to undertake any function not mentioned in the legislation.

Proposed new legislation would change the basis of the controls on building societies so that rather than being allowed to do only those things permitted in the legislation, they would be allowed to do anything unless it is expressly prohibited by the legislation. The Bill proposes that 75% of building society lending shall be on the security of housing (irrespective of whether it is owner occupied or rented) while the remaining 25% can be invested in any asset. There may well be a debate about the wisdom of allowing specialist financial institutions to diversify; on the other hand, some may question the wisdom of forcing building societies to keep all of their eggs in one basket - the housing market. Those who fear that building societies may be stirring up difficulties by moving into new and unfamiliar areas will be reassured by the fact that it is proposed to strengthen the powers of the Building Societies Commission, probably the most successful of the financial services regulators created in the 1980s. Indeed, the building society sector has been almost unique in not being rocked by scandal in recent years. There has been nothing to match the disasters that have hit Barings and BCCI in the banking sector, Barlow Clowes and Roger Levitt in the financial advisor area, Maxwell and the sale of personal pensions in the pensions area, or Morgan Grenfell in the unit trust market. Repeated market research exercises show that building societies have a uniquely warm relationship with their customers which is based partly on the skills to be found within the supervisory regime.

The third element of the new mutualism is accountability of societies to their members. Building societies have been accused of not being as accountable as plcs. There is not space to go into that debate within the confines of this paper, however, the new legislation proposes a range of initiatives, many suggested by building societies and the Building Societies Association (BSA), to improve accountability. These include the granting of voting rights, currently held only by investing members, to borrowers, the requirement to hold a ballot to determine the membership of the board even where the number of candidates equals the number of vacancies, a requirement to list candidates in alphabetical order, an obligation to consult members where the society is making a significant investment outside its core business areas, and an obligation to list the results of the elections for the board in branches. The Association has taken two initiatives. First, it has published a booklet *Your Rights as a Member of a Building Society* which describes the constitutional (rather than contractual) rights relating to various corporate governance issues of members of a building society. The Association has also sent to its members a circular giving advice on the nature of the information which they should give to individuals contemplating standing for election to the board.

Finally, new mutualism has rediscovered the ethic of being a mutual institution, of realising that building societies exist to serve customers and their local communities, rather than any other group. A number of societies have taken various initiatives to abolish obsolete savings accounts, and also to offer special benefits to long standing mortgage customers not available to new borrowers. Most societies also provide assistance to a range of local charitable and community organisations operating in the area of their head office, ranging from Citizens' Advice Bureaux giving money advice, to sponsorship of local sports leagues.

I indicated at the beginning of this paper that there was renewed interest in encouraging co-operation between mutual institutions and a realisation that some of the issues which faced building societies, industrial and provident societies, credit unions, co-operative organisations and mutual life companies in today's environment were very similar. This year the BSA has hosted two lunches at which the guests have been leaders of various mutual institutions. Guests have included senior executives from friendly societies, mutual life companies, BUPA and the Automobile Association, and work is currently being undertaken within the BSA on whether there is scope for further joint work between mutual organisations.

Building societies have been through a period of self doubt and confusion as each has examined why they exist and what they should be doing. They have learnt that success in the past is no guarantee even of existence in the future. Some have concluded that their future lies outside the mutual structure. Others, however, have taken the initiative and brought new life and vigour to the concept of building societies. One of the most fascinating experiences in British commercial life is about to begin, with direct competition between mutual and stock based institutions in one of the key financial markets. For both sides the stakes are high, as the market will show which of the two approaches adopted by those institutions currently called building societies proves successful.

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