The Case for Building Societies

by the Building Societies Association

INTRODUCTION

The Building Societies Association welcomes the decision by the Treasury Select Committee to hold a short inquiry into the recent trend in mutual organizations, including building societies, to become limited companies with shareholders. The Committee wishes to examine whether mutuals possess any special character that brings benefit to members not shared by customers of nonmutuals, whether there is a case for strengthening the position of mutual organizations which do not wish to convert and the effectiveness of current regulation.

The BSA Believes :

a. that mutuals do possess special characteristics that bring benefits not only to their members but to the financial system as a whole;

b. that these benefits represent a strong case for strengthening their position; and

c. that the current regulatory and legislative provisions governing conversion of building societies to plc status, designed more than a decade ago, inadequately address the issues raised in the current environment.

This article is the text of a submission by the Building Societies Association to the Treasury Select Inquiry into Mutual Organizations, June 22, 1999.

This submission to the Treasury Select Committee briefly describes :

a. the role of the Building Societies Association;

b. the role of building societies;

c. the advantages of the building society model for both members and the financial system as a whole;

d. the reasons that some building societies have converted;

e. the difficulties faced by the remaining societies as a result of the inadequacies of the current legislation;

f. the ways in which they have partially overcome these difficulties; and

g. societies' proposals for legislative change in order, particularly, to enhance the democratic rights of borrowing members.

THE BUILDING SOCIETIES ASSOCIATION

All 70 building societies authorized to accept investments in the United Kingdom are members of the Building Societies Association. The Association represents the interests of its members to government, civil servants, MPs and Peers, the media, the City and others, and provides societies with the information which they need to run their businesses as effectively as possible. The Association does not regulate the activities of societies.

THE ROLE OF BUILDING SOCIETIES

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 Table 1.

Table 1. Building Societies: Key Data, Year-End 1998

Assets	£150	billion
Branches	2,400	
Staff	40,000	
Investors	16	million
Borrowers	2.9	million

Note: All statistics exclude Birmingham Midshires Building Society, which converted in April 1999, but include Bradford & Bingley Building Society, the board of which has recently announced its intention to put a formal demutualization recommendation to its members.

Building societies currently account for about 23% of all outstanding residential mortgages in the United Kingdom and about

17% of all personal sector deposits held by building societies, banks and National Savings; they account for about a third of new business in these areas. A number of societies also offer related products such as offshore deposit accounts, checking accounts, credit cards, stockbroking services and estate agency; most also sell a range of insurance products.

Two societies own their own life insurance subsidiaries, but the remainder sell or arrange the provision of products "manufactured" by life insurers, acting as independent financial advisers, tied agents or introducers under the polarization 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; they raise about 20% of their funds from the wholesale markets, rather than individual investors.

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 nonresidential 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 (i.e., 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 by the Treasury.

b. Societies must raise at least 50% of their funds from members who are individuals.

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 to 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 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.

Regulation

Societies are regulated on prudential issues by the Building Societies Commission, a statutory body established under the 1986 Act. The Commission is appointed by HM Treasury and reports annually to Parliament. Building societies which sell products regulated under the Financial Services Act (life insurance or unit trusts, for example) are also regulated by the appropriate self-regulating body established under that Act. The Commission will disappear under the proposals contained in the Financial Services and Markets Bill, and societies will then be regulated by the Financial Services Authority, with which the Commission already has a service agreement. Building societies are also signatories to the industry-wide codes of practice covering banking and mortgages.

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 (in practice, fairly modest) 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.

d. The number of members required to support the nomination of a candidate for the board was, for many societies, reduced.

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, eight societies have demutualized, accounting for more than two-thirds of the total assets of the sector in 1994. (Details are shown in the appendix.)

Just three of the then-10-largest societies remain mutual; and one of those, Bradford & Bingley, has announced its intention to put a formal demutualization proposal to its members. The remaining societies have been under some media and member pressure to follow this trend and also demutualize. 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%. 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.

Narrower Margins

The first set of data relates to the margins under which building societies and comparable plcs operate. Table 2 shows figures for 1998 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 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, check books, etc., which carry higher margins), their overall margin is slightly inflated.

Table 2. Margin Comparison for Converted Institutions and Building Societies, 1998

	Interest Margin %
Halifax bank	2.43
Abbey National bank	2.39
Woolwich bank	2.16
Alliance & Leicester bank	1.82
Northern Rock bank	1.70
Nationwide BS (yr to April '99)	1.72
Bradford & Bingley BS	1.31
Yorkshire BS	1.22
Coventry BS	1.24
Skipton BS	1.40
Chelsea BS	1.47
Leeds & Holbeck BS	1.35

Source: Individual accounts or press statements

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 summarized below:

a. A survey published in the March 1999 edition of the specialist magazine, *What Mortgage?* found that out of 73 lenders, the cheapest 30 over 10 years were all mutual building societies. Building societies have increased their number of top places in this survey from 25 in 1997 to 27 in 1998 and 30 in 1999. In the shorter term, a survey published at the end of 1998 by The Research Department of the largest 30 lenders found that nine of the 10 cheapest over the previous three years had been building societies. The specialist publication *Moneyfacts'* analysis of the cheapest lenders over the year in 1998 also found that nine of the cheapest 10 lenders were building societies.

b. On the savings side, a *Moneyfacts* study of the performance of TESSAs over the previous five years found that eight of the best 10 performing accounts to the beginning of 1999 were from building societies. The same survey carried out covering the five years to the beginning of 1998 came to the same conclusion.

c. A survey conducted on behalf of the BBC *Radio 4 Today* program in the spring of 1998 asked 978 adults, "If you wanted to get a mortgage, who would you trust most to help you choose the best one for your circumstances?" Forty-four percent 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 organization MORI undertook research in February and March 1999 of around 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 8% of the journalists interviewed agreed that "the conversion and takeover of building societies will result in a better service for customers." Seventy-eight percent disagreed with this statement. A resounding 77% of journalists also agreed that "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 creditworthiness of an institution. The absence of external shareholders means that building societies will always have a 'margin advantage' over plcs."

Market Share

The third piece of evidence suggesting that building societies' products are relatively attractive to customers lies in the data for market share. As noted, building societies account for about 23% of outstanding residential mortgages. However, in 1998 building societies were responsible for 33% of net new mortgage advances (net indicates that the figure takes account of redemptions on existing loans). Similarly, in the market for retail deposits, building societies, with 17% of outstanding deposits at the beginning of the year, accounted for 31% of the increase in deposits during the year. Data for the performance of the converted institutions in 1998 is shown in Table 3.

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 1998. The figures for 1997 were similar.

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 19th 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 checks payable to third parties such as utilities. Many societies find that their

Table 3. Market Share of New Banks 1998 Percentage

	Mortgages Outstanding	*Net 98*	*Savings Outstanding*	*Net 98*
Halifax	19	5	14	3
Abbey National	14	6	9	5
Woolwich	6	4	4	(£257m)
Alliance & Leicester	4	5	3	(£1,200m)
Northern Rock	3	7	2	4

Source: Individual Annual Reports

instant access accounts are used as a quasibanking account with wages paid in on a weekly basis and the majority of funds withdrawn either by check or cash during the next few days. These accounts also offer a check-cashing service. Checks can be paid into the account, and the equivalent amount of cash withdrawn, again without charge. A checkcashing company would typically charge 7% to 8% of the value of the check. 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 modernized this process by offering accounts involving some money transmission facilities including check books, standing orders, direct debits and plastic card access to the account. One large society, soon to be followed by another, has specifically met the requirements of the financially excluded as identified by the Rowntree research by launching an account that offers 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, either 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 later in the year.

In summary, building societies can be seen as agents for 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

The presence of building societies offers advantages not only to building society members but also to the financial system as a whole. The Association believes that 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.

Second, 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 reguirement 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.")

Third, 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.

There are also advantages in geographical diversity. The majority of building societies are regional or local institutions, owned and run in different parts of the United Kingdom, rather than from London. There is a head office of at least one building society in all 12 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.

A fifth factor is that building societies are systemically risk-averse because they can-not 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. They 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.

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 recognized 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.

It has been suggested that newcomers to the banking market, such as supermarkets, insurance companies 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?* reports 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 subsidize 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 organizational 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 counterarguments 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 Association, 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 to the Committee. 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 announced or implemented plans to return 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 Building Society, 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 exercizable 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 program 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 the only private sector bank 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.

PRESSURES TO CONVERT

Given the advantages of their continued mutual status and the lack of attraction of conversion, it might be wondered why societies are under pressure to convert. The answer lies in the prospect of individual members gaining a substantial short-term return on a relatively small investment. It should be noted that the Government and Parliament of the day was very concerned, when considering the details of the Building Societies Bill 1986, to prevent such a motivation for conversion becoming the deciding factor. The government spokesman in the House of Lords, Lord Brabazon of Tara, said during the debate on the conversion provisions of the legislation that:

> "The Government are concerned that adequate safeguards should exist to secure that conversions happen for reasons of commercial development and are not decided by the prospect of possible short-term gains. As the Government have also made clear ever since they published their consultative document on building society conversion in December last year, it is important that the conversion provisions work to prevent speculative flows between societies on rumours of an impending conversion. I gather that is what happened in America in certain situations, and that is what we seek to avoid happening in this sort of situation." (*House of Lords Hansard,* July 10, 1986, column 539)

It is clear that the legislation has failed to adequately address this issue. Moreover, institutions keen to convert have undermined and exploited the legislation in ways not anticipated by those who framed it. The conversion of some societies has resulted in the distribution of cash or shares to the value of over £2,000 to borrowing and investing members. Members with relatively small deposits have received significant payments, as under the one member one vote system each member's vote is of equal importance to a management seeking to ensure that a conversion resolution is passed. The payments to investors have been sufficient to generate two phenomena.

First, large numbers of individuals have sought to open accounts with building societies in the hope of obtaining short-term benefits in the event of the society demutualizing. Indeed, at times the flood of so-called carpetbaggers has been such as to disrupt the affairs of societies. Queues of people anxious to open accounts have prevented societies from offering their normal level of service to existing customers, and many societies have had to introduce restrictions in order to reduce the pressure—by asking for a significant minimum balance, for example, or restricting account openers to the locality around their head office. The building societies are in no doubt that carpetbagging is unjust. These individuals join a society in the hope of benefiting from its dissolution, having made no contribution to its development during their short period of membership.

The second problem faced by building societies relates to the view of some carpetbaggers that they should not merely wait for the society to demutualize but take active steps to force such an event to occur. In 1997 there was a contest for the election of directors to the board of Nationwide Building Society. The five retiring directors recommended by the Board for reelection were faced with opposition from five candidates standing on a proposal to convert the society to plc status. The candidates were able to offer voters the prospect of a substantial bribe in the form of shares or cash in the event of conversion in order to entice voters to support them. In the event, about 73% of those voting backed the existing board. In 1998 Nationwide faced another threat to its continued existence as a mutual when one of the candidates who stood in 1997 renewed his candidature and also put forward a resolution that the society convert to plc status. The board candidature was lost on an approximately 40/60 vote. The resolution to convert was lost 49.2% to 50.8%.

In 1999, 70 members of Bradford & Bingley Building Society proposed at the society's AGM that the society convert to plc status and distribute shares. That resolution was passed by 62% to 38% on a 63% turnout. The society immediately announced plans to convert, even though, in a parallel vote conducted within the AGM structure, the majority of borrowers voting voted 60% to 40% to retain the society's mutual status.

The case of Bradford & Bingley is instructive. For the first time the initiative to convert has been taken not by the board and management of the society but by the membership. Also for the first time the reasons articulated for conversion have not related to access to capital, new products, increased accountability or the philosophical features of mutuality and plcs; rather, members voted to obtain a distribution of cash or shares—precisely the factor which Parliament sought to address in 1986.

The likely provision of a cash lump sum makes member votes on the future of building societies the only electoral process in the western world heavily influenced by the prospect of receiving cash in return for voting in a particular manner.

It should be noted that there are no restrictions on the claims, no matter how extravagant or untrue, that can be made by the proposers of a resolution to convert on the amounts available for each member in the event of conversion.

With Bradford & Bingley, for example, the promoter of the resolution suggested that each member could receive £2,000. It is extremely unlikely that, in the event, such an amount could be distributed. However, the society had no legal right to change the figure put forward by the proposer of the resolution, and this was the figure that was circulated to members.

A fourth example is represented by the case of the Britannia Building Society, which faced a contested election for board membership at its AGM in April 1999. The candidate for election to the board, standing on a proconversion platform, chose to withdraw from the contest virtually on the eve of the vote. As a result, the voting form was legally invalid and the society was forced to postpone the election, reconvening its annual general meeting a few weeks later. Individuals do not need to be a member of the society to stand for election, and this individual now has the means to be renominated by the necessary 50 members year after year, repeatedly withdrawing from the election and causing similar disruption on an annual basis. This year's disruption proved to be a very costly exercise for the Britannia, as it had to reballot all of its 1.25 million members, asking them to vote again on a ballot form that no longer included the name of the individual who withdrew.

Finally, seven societies were requested, by one individual, to put resolutions on conversion to their members at their 1999 annual general meetings. The same individual also sought nomination to the board of each society. In the event, legal advice showed all the resolutions to be invalid, as were the nominations (with the exception of the Britannia, the board election of which is described above). The inadequacies of the legislation highlighted by the Bradford & Bingley vote would have been even more obvious had these additional votes actually taken place.

ACTION BY SOCIETIES

The most important action taken by societies has been described above: societies must offer their members a demonstrably better deal than they can obtain elsewhere and properly explain to their members how their mutual status enables them to deliver that better deal. Many societies have radically improved their programs of communication with their members so as to convey this message.

In addition, societies can take constitutional action within the current legislative framework to protect themselves and the long-term interests of their genuine members against the actions of carpetbaggers seeking to force the society to convert. This section describes the action so far taken, while the next section puts forward proposals for legislative change which would enable societies to strengthen the long-term position of their members further.

The most important changes made by societies are as follows:

a. **Increasing the minimum balance required to open and operate an account.** In the past many societies operated on minimum opening balances of £1, £10 or £100; but these have been replaced by figures of perhaps £1,000, £2,500 or even, in one case, £5,000. Such changes to account opening procedures undoubtedly slow the flow of carpetbaggers opening new accounts and stops queues forming which disrupt normal business. However, they simultaneously take a society away from its main reason for existence on the savings side—to offer facilities to the small saver. This is not a particularly attractive course of action to take for societies, especially amid concern about financial exclusion.

b. **Geographical restriction.** A number of societies have decided to accept deposits only from their local area of operation. This again slows the flow of carpetbaggers, but denies many genuine investors the opportunity of investing in a society of their choice and inhibits the efficiency of the financial system.

c. **Charitable assignment.** In order to overcome these problems, the Nationwide Building Society, in November 1997, introduced a charitable assignment scheme which requires individuals opening a savings or mortgage account to assign any windfall that might come their way as a result of conversion to charity. Simultaneously, the account opener becomes a member of the Nationwide Charitable Foundation, which now has 1.4 million members. Eight other societies have adopted a similar approach, although the details of the individual schemes have differed.

d. **Rule changes.** For a formal conversion proposal put by a board of directors to the membership to succeed, there must be separate votes of borrowing and investing members. Fifty percent or more of investing members have to vote, and of these 75% or more have to vote in favor of the proposal. For borrowers there is no turnout requirement, although a majority of those voting must vote in favor of the proposal for the conversion to go ahead.

However, the law does not similarly subject an ordinary resolution put forward by members which deals with conversion to similar requirements. The rules of the Bradford & Bingley Building Society provided that such a resolution would be a valid expression of members' views if it was passed by more than 50% of those voting in a single constituency (that is without separate votes for borrowers and investors). The Bradford & Bingley voting figures were noted above and would not have met the statutory requirements; nevertheless, the Bradford & Bingley board decided to begin the process of preparing for conversion.

At their 1999 annual general meetings members of 17 societies voted to change the rules of their societies to require that a members' resolution dealing with conversion would not be a valid expression of members' views unless it was supported by 75% of those voting in a single constituency. (The law recognizes separate borrowers and investing members' resolutions only in relation to a formal board proposal to convert; it is not possible for societies' members to change the rules to incorporate this feature of the legislation.)

PROPOSALS FOR LEGISLATIVE CHANGE

While building societies can do a great deal to guard their members' long-term interests, there remains a fundamental anomaly in the legislative structure governing societies' activities. It remains possible for individuals to join a society, to make no contribution to either the society's affairs or to its finances, and yet still have a vote within a short period of joining which they can use to convert the society to a plc. Not only does this mean that they gain control of resources in an unfair manner, their action also denies future generations the opportunity to earn attractive savings rates or pay relatively low mortgage rates.

Moreover, recent evidence, from Bradford & Bingley, suggests that the intention of Parliament in preventing the majority of investors outvoting a minority of borrowers is failing. It was noted earlier that member support for a board resolution to convert must be shown in two constituencies, both borrowers and savers. Investors are relatively numerous, with the majority investing small amounts in accounts withdrawable at relatively short notice. Their commitment to the society is somewhat less than that of borrowers, who generally borrow relatively large sums and find it more difficult to move their loans elsewhere, despite the emergence of the remortgage market. It was correct for Parliament to seek to protect borrowers from being outvoted by the more numerous investors (by introducing a separate borrowers resolution) when the Building Societies Act 1986 was passed. Given the rapid influx of new investors in societies it remains more than ever the case that borrowers, with a large committed relationship with a society, should be protected from the short-term interests of numerous uncommitted small investors seeking to obtain cash or shares on the conversion of the society.

The final difficulty with the legislation is that relatively small numbers of members can disrupt the affairs of a society by calling for a vote on its constitutional status. For the largest societies, just 50 individuals are required to support a nomination to the board, even though such societies have hundreds of thousands of members. The figure is related to the size of the society and for the smallest societies, just 10 individuals are required to support nominations. Similarly, only 50 members are necessary for a members' resolution to be submitted for consideration at an annual general meeting. These numbers were relatively difficult to achieve in the past, but the advent of the Internet has made it much easier to assemble the necessary numbers of promoters of a resolution or board candidate.

Recent events have also shown how easy it is to disrupt a building society's annual general meeting. Indeed, for those that wish to disrupt, a template has been created by this year's events at Britannia Building Society.

In the light of these developments, the Association proposes that for all conversion resolutions, whether proposed by members or formally proposed by the board, there should be separate constituencies of borrowers and investors, with motions to convert (or to express support for the idea of conversion) being passed only if in each of the constituencies there is a 50% turnout and 75% vote in favor of conversion. This would strengthen the position of borrowers. The Bradford & Bingley experience has shown that borrowers can be outvoted on a members' conversion vote.

The Association recognizes that this would require primary legislation, which may not be possible in the short term. If this is the case, there are changes that can be made relatively quickly through secondary legislation. Such legislation could be used to increase the minimum number of individuals required to nominate candidates for the board, to propose resolutions or to requisition special general meetings. The Association believes that each of the current limits should be multiplied by 10 so as to provide equivalent protection for societies' borrowers and longer term members from the actions of small minorities seeking to manipulate societies' affairs for their own ends. It is not unreasonable in a society with hundreds of thousands of members for substantially more than 50 members to have to support a candidate or resolution before it can go forward for consideration by the entire membership.

The Association also believes that the majority of societies' members must be protected against those who seek to manipulate the rules to disrupt AGMs, as happened at the Britannia Building Society this year. The Association recommends that candidates withdrawing from an election to the board should be prevented from standing again for three years, and that in addition, the result of the poll remains valid if one or more candidates withdraw after the ballot papers have been distributed. This proposal would require primary legislation.

Finally, the Association believes that new members of societies should receive the full rights of membership, including the rights to vote and propose motions, only after they have been members for two years, and have had a chance to both make a contribution to, and understand the affairs of, the society. Currently, an individual is able to join a society just before its year-end and vote at its annual general meeting less than four months later. (Indeed, it had been believed that the Building Societies Act 1986 restricted cash and share distributions on conversions so that members of less than two years standing could not receive such payments. However, following three court cases relating to the Abbey National, Cheltenham & Gloucester, and Halifax conversions respectively, it is clear that the legislation does not fulfil Parliament's intention in this respect.)

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. The difficulties that building societies currently face are a result not of fundamental weaknesses relating to the mutual model but rather of legislative inadequacies relating to the provisions covering the conversion of building societies to plc status.

Building societies do not seek Government "intervention" to "protect" them. Parliament, on the advice of Government, framed the rules relating to conversion in 1986 and therefore already directly intervenes in building society affairs. Building societies now seek an alteration in that intervention because it has neither kept up with the times, nor fulfilled its original purpose. The legislation has been manipulated to the advantage of members who wish societies to convert, against the longer term interests of those who benefit from mutuality. Building societies were established by past generations and their reserves have been built up so as to enable the current generation to obtain cheaper mortgages and higher savings rates than would otherwise be the case. It is wrong that the current generation is allowed to take for itself the benefit of the reserves built up in the past and to deny future generations the opportunity to obtain the same benefits. Even if one accepts the view that the current generation is being adequately compensated for the loss of its cheap mortgages and attractive savings rates by the distribution of cash or shares, no compensation will be payable to future generations looking for competitive financial products.

If nothing is done now, there is a significant risk that large numbers of investors in building societies with only a short-term connection will destroy the sector for their own ends. If this happens, a Government enquiry will probably be launched in five years time, seeking to examine the reasons why the providers of the most competitive basic financial products in the country were allowed to disappear.

Appendix. Building Society Conversions 1995 to 1999

Building Society	*Mortgage Assets end 1995 £bn*	*Market Share %*	*New Status*	*Date of Change*
Cheltenham & Gloucester	15.4 (end 94)	4.1	Subsidiary of Lloyds TSB Bank	August 95
National & Provincial	10.4	2.7	Subsumed by Abbey National	August 96
Alliance & Leicester	16	4.1	Quoted Bank	April 97
Halifax	77.2	19.8	Quoted Bank	June 97
Woolwich	21.8	5.6	Quoted Bank	July 97
Bristol & West	6	1.5	Subsidiary of Bank of Ireland	July 97
Northern Rock	8.8	2.3	Quoted Bank	October 97
Birmingham Midshires	5.2	1.3	Part of Halifax	April 99

Note: Abbey National, formerly a building society, became a quoted bank in July 1989.