Mutuals and Stock Institutions: Battle Commences in the United Kingdom

by Adrian Coles

INTRODUCTION

The financial services sector in the United Kingdom, as in many other countries, is undergoing fundamental change. Barriers between different financial institutions and products are breaking down, and the corporate form of organizations is changing. In the United Kingdom, change has been particularly marked in the building society sector. This paper covers the background of the decisions by a number of large UK building societies, representing two-thirds of the entire sector, to de-mutualize (thereby converting to bank status); discusses briefly some of the factors that lead to demutualization of building society-type institutions outside the UK, but which are not present in the UK; and looks at the "new mutualism" through which the remaining building societies are redefining their reason for existence.

TRENDS IN THE HOUSING MARKET

In order to understand what is going on in the UK building society sector, it is necessary to take a step back and examine trends in the UK housing market over the last 10 years. As in many other countries, 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 buoyant conditions which characterized even the mid-1980s, let alone the years towards the end of that decade.

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There is a range of factors suggesting there has been a fundamental change in the way the housing market behaves. In summary, these factors are:

1. 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.

2. Government assistance to owner occupation has been reduced. In particular, the retention of the £30,000 limit on the size of mortgage eligible for tax relief on the interest paid, the abolition of higher rate tax relief, and the reduction in the standard rate of relief to 15% (although the basic rate of tax will shortly fall to 23%) means that during 1996 tax relief accounted 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 welfare support for unemployed mortgage holders, so that much less assistance is available to this group.

3. Conditions in the labor 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 job market and earlier retirement are all features of the new employment scene. All of these factors militate against the traditional 25-year mortgage, although their impact has been ameliorated to some extent by the significant improvements in mortgage design in products launched over the last two years. Many of these, for example, allow interruptions in the normal monthly payments.

4. Demographic change. There was a one-third reduction in the UK birth rate between the 1964 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; this decade 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.

5. Finally, there has been increased interest in the private rental sector; government controls on rents have, broadly speaking, been abolished. The Business Expansion Scheme (in effect, a generous subsidy system to investors in private rented housing, withdrawn in 1993) 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 net mortgage advances (total new advances minus repayments) amounted to little more than £19 billion, compared to a peak figure of £40 billion in 1988. Transactions have dropped during the same period from 2.1 million to 1.2 million. Both figures have changed relatively little over the last two or three years. Until recently, however, 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 realization grew that there would be no return to the earlier conditions, it was argued by many that there was a need for a new approach to the market. Two factors changed in response to the market conditions—pricing policy and corporate form.

Pricing Policy

As the recession deepened and as it became more difficult to obtain new business, lenders were forced to adopt ever more attractive and adventurous pricing strategies to attract new customers. The most popular has been the widespread practice of offering discounts off the normal variable rate for the first year or two of a mortgage. Such discounts have on occasion enabled borrowers to obtain their mortgage free of interest payment for the first six or 12 months, although typically a discount of 3% to 4% (from a mortgage rate of 7% or 8%) is offered for between one and three years. Alternatively, many lenders offer cash-backs: borrowers are sent a check for, typically, between 3% and 6% of the loan value soon after the loan is completed. All such deals are tied to lock-in contracts so that the customer has to repay the discount, or cash, if they re-mortgaged elsewhere during, typically, the first five years of the repayment period.

Such deals proved extremely attractive to existing customers of mortgage lending institutions. Each lender faced a situation in which it lost borrowers to other institutions offering special incentives, which could not possibly be offered, because of the cost, to all existing borrowers. Each lender was therefore forced to offer ever more attractive deals to new borrowers in order to replace the existing borrowers which it had lost to the ever more attractive deals offered by its competitors. This merry-go-round of, in effect, exchanging customers, continued throughout the mid-1990s, albeit in slightly less virulent form in recent months. It did little, however, to address the fundamental issues in the mortgage lending sector.

Corporate Form

The fundamental factor remained overcapacity. In the spring of 1994 the Cheltenham & Gloucester Building Society (the sixth largest with assets of £17 billion) announced that it intended to transfer its business to Lloyds Bank, with the ultimate intention, now fulfilled, of becoming the specialist mortgage lending arm of Lloyds Bank (which has since merged with TSB to create Lloyds TSB). Cheltenham & Gloucester was relatively under-branched but very efficient and is now able to distribute its products through the Lloyds Bank branch network. Processing of both Lloyds and C&G mortgage lending is centralized in Gloucester, enabling Lloyds Bank to use the capital previously tied up in mortgage processing to greater effect.

Following this path-breaking deal, the Halifax and Leeds Permanent building societies announced in November 1994 their intention to merge (under the Halifax name) in August 1995 and convert to bank status in 1997. Over the last two years there have been a range of further consolidations, shown in Table 1.

Despite these changes, the remaining building societies have mortgage assets in excess of £100 billion and profits of £1 billion a year. The largest societies committed to retaining their mutual status are Nationwide (with mortgage assets of £26.3 billion and a market share of 6.7%), Bradford & Bingley (£11.6 billion, 3.0%) and Britannia (£8.3 billion, 2.1%).

THE IMPACT ON MUTUAL BUILDING SOCIETIES

Mergers

The Cheltenham & Gloucester and subsequent announcements significantly changed the environment in which building societies operate and, more particularly, merge. Members of building societies suddenly realized that their membership was worth a great deal, even though they had paid nothing for it. The average cash payout (implemented by crediting savings accounts) to Cheltenham & Gloucester investors, made by Lloyds Bank to effect the change of ownership, was over £2,000. In the case of the four societies becoming quoted banks, equity shares are being distributed to both investors and borrowers, worth, on average, over £1,000, although the exact value will depend on stock market conditions at the time of flotation.

Table 1. Building Society Conversions

Building Society	*Mortgage Assets end '95 £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	16.0	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	6.0	1.5	Subsidiary of Bank of Ireland	August '97 (approx.)
Northern Rock	8.8	2.3	Quoted bank	October '97 (approx.)

Notes: 1. The expected date of change of status is shown, where appropriate. 2. Abbey National, formerly a building society, became a quoted bank in July 1989.

It is not possible to implement either of these options 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 emerging from another financial institution which would result, if implemented, in a significant payout to the members of the society seeking to merge. There is at 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; those that have taken place have involved relatively small societies for which conversion is effectively impossible.

"Carpetbaggers"

There has also been a significant impact on the continuing business operations of building societies. Given that membership in 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, occasionally, in queues of people outside building society branches seeking to open accounts. Such individuals have come to be known as "carpetbaggers." Their appearance has reduced the level of service which affected societies have been able to offer 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. Overall, the perverse effect has been to encourage societies to turn away small customers, although given that the vast majority of funds held by societies is in fairly large accounts, this has had no major business consequences.

Duties of Directors

A further matter for consideration, which was not the subject of debate before the Cheltenham & Gloucester announcement, concerns the duties of directors. Members of boards of building societies have been forced to examine their role. Are directors of 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? Interestingly, although there have been large numbers of new account openings, there has been little member pressure to convert.

ADVANTAGES OF THE STOCK FORMAT

The key advantage of the shareholder-based format is that it enables the institution concerned to more readily take part in the rationalization 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 important, a society that has converted to company 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 regulation contained in the current Building Societies Act giving five years' protection from takeover to converted societies (but see the later section on a proposed new act). This feature 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; in current conditions the provision gives a converting society an advantage in the race to consolidate.

A third major factor, and the most important to the public eye, has been the ability of the converting societies to give away money (or shares which can be turned into money) to customers at no apparent cost. Moreover, since 1989 UK retail bank shares have strongly outperformed the UK all-share index, which itself has been enjoying a record upward surge of almost 100%. This makes it increasingly attractive for the owners of the societies (i.e., the members) to sell their ownership interest.

There is a range of other advantages claimed for conversion:

- The banking legislation provides greater freedom to operate, compared to building society legislation. (However, it is clear that the converting societies are planning to concentrate on those markets that are already open to them as building societies.)
- The plc (public limited company) form of ownership engenders greater accountability on the part of managers to owners. (This is hotly debated.)
- It is possible to separate out the customer/owner relationship, so that individuals can be customers, while realizing their ownership status. (This, however, creates a conflict of interest between the customer and the shareholder not present in a mutual.)
- Diversification into new and unfamiliar areas should be supported by risk capital rather than the capital built up from the relatively safe savings and mortgage business. (There is, in fact, no reason why mutual institutions should not form subsidiaries to offer a wider range of services to their members.)
- It is suggested that the size of an organization itself precludes organization along mutual lines. (This argument 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.)

DEVELOPMENTS OUTSIDE THE UK

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

1. The desire to obtain bank status. In all of the countries mentioned, building societies and other similar organizations 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, thus providing status and prestige in both the wholesale and retail markets. It is notable that in the UK those institutions that have converted, or intend to, do not and will not use the word "bank" in the name of their organization because it is not a word that, it is believed, would enhance their business. It is Abbey National plc, for example, rather than Abbey National Bank plc.
2. 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.
3. 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.
4. 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 recapitalize the business. British building societies are relatively well capitalized, and again, this has not been a motivation for conversion. No new capital, for example, is being raised by the four societies converting to independent quoted status.

Interestingly, and as noted earlier, there has not been a similar wave of demutualization 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 organization to its members.

NEW MUTUALISM

Return of Value to Members

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 rationalization in the mortgage lending sector and the greater ease with which this can be undertaken within the stock rather than mutual format. Some might take this to be a convincing case for demutualization. Why then have about 70 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. Many societies hold their base variable mortgage rate 0.25–0.5 percentage points below the "plc rate" and are still able to offer a similar additional amount on their savings rates. In the light of the mortgage price war, building societies have taken the lead in offering discounts to their existing customers of, say, three or five years standing. The Britannia Building Society has gone down a so far unique route, offering its members a share of the profits made by the organization, 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 inherent in their corporate status. The answer is that the early 1990s were characterized by a rapid growth in arrears, and most notably possessions, on which all mortgage lenders, including building societies, suffered 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 decade 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.

New Legislation

The second element of the new mutualism is unrestricted powers for building societies. The Building Societies Bill is proposed to be introduced into Parliament during 1997, although there is some uncertainty regarding the exact timing because of the forthcoming general election. In summary, 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, check 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 can enter only those markets, and can undertake business only in a manner, prescribed by the legislation. It remained illegal for a building society to undertake any function not mentioned in the legislation.

The proposed 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 with one or two exceptions. It is also proposed to strengthen the powers of the Building Societies Commission, probably the most successful of the financial services regulators created in the 1980s.

One of the most important areas of debate during the public consultation on the Bill has been the fate of the five-year rule, referred to earlier. The current legislation states that no individual, or connected group of individuals, can own more than 15% of the shares in a quoted former building society for the first five years of its quoted existence. During this period they can, however, acquire other financial institutions, including the continuing building societies.

A strong body of opinion has emerged that organizations that want the advantages of a stock market listing should also accept the disadvantages, such as the threat of takeover. The Halifax has accepted this argument and voluntarily given up its protection. The government has compromised and stated that this protection should be lost if a converted society acquires another financial institution. Such a proposal has been included in the draft bill, but has met opposition from the smaller societies due to convert, on the grounds that the change in policy is unfair, because it was announced after they had announced their intention to convert. It remains to be seen how Parliament will resolve this dispute.

Accountability

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 companies. 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 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 BSA has published a pamphlet, *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.

Focus on the Customer and the Community

Finally, new mutualism has rediscovered the ethic of being a mutual institution, of realizing that building societies exist to serve customers and their local communities, rather than any other group such as external shareholders. A number of societies have taken various initiatives to abolish obsolete savings accounts (that is, accounts that were once heavily advertised and offered attractive rates of interest but which have since been downgraded) and also to offer to long-standing mortgage customers special benefits not available to new borrowers.

Most societies also provide assistance to a range of local charitable and community organizations operating in the area of their head office, ranging from Citizens Advice Bureaux giving debt advice, to sponsorship of local sports leagues. Societies continue to enjoy a much warmer relationship with their customers than any other set of financial institutions in the UK.

Economic Consequences of the Conversions

It is estimated that the free shares being distributed to the members of the soon-to-be-converted societies will be worth £20 billion when the flotations finally occur. This is a huge sum, equivalent to 6 to 7 pence off the 23 pence in the pound basic rate of income tax, and also equivalent to 3.5% of estimated personal disposable income in 1997—in other words, one year's inflation-adjusted growth in income.

In addition, there is the locked-in funds phenomenon. It takes a long time to convert a building society into a bank. So far, the minimum time from announcement of the decision to convert to vesting day has been 15 months. In the case of the Halifax, which also had to cope with its merger with the Leeds, the period between announcement and actual conversion will exceed 2.5 years. A key task during this period is to deduplicate accounts to ensure that each member receives the right information on the proposal, voting papers for the general meeting of members to confirm the conversion and crucially, the free shares.

During the period between announcement and flotation invested funds have been regarded by many members as locked in. If an investor (or borrower) is no longer a member at the flotation date, the right to free shares is lost. With those societies that are relating the number of free shares to the saver's overall investment, withdrawals of savings could reduce the number of free shares to which the saver is entitled.

Overall, it is expected that there will be significant withdrawals of funds from, and repayment of mortgage loans to, the converting societies once they have actually converted, especially as there is evidence that the converting societies have paid less than market rates on savings locked in by the promise of free shares. At the end of 1995 the converting societies had retail savings balances of around £125 billion. If £10 billion of these funds were withdrawn, this would represent a further significant flow of funds through the economy in 1997. The way that these flows will impact on the economy will depend on:

- The proportion of the free shares that are held or sold. It is generally believed that about 25% of the new shareholders will sell immediately.
- The proportion of the funds resulting from the sale of shares (and the "unlocking process") that are spent or saved elsewhere (this term including repayment of debt).
- The proportion of that spent which is used to acquire domestically produced, as opposed to imported, goods.
- The extent to which the increased demand for domestically produced goods is met by increased output or higher prices.
- The reaction of the government and Bank of England to the emerging trends.

CONCLUSION

Building societies have learned 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 vigor 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 some of the key personal 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.

Moreover, 1997 will see the results of a huge economic experiment. What will the British public do when it is given £20 billion apparently for nothing, and in addition regains access to savings accounts which have been locked in for over a year? A crucial chapter in British economic history is about to begin.