ANNUAL REPORT 2002

BUILDING SOCIETIES ASSOCIATION

ANNUAL REPORT 2002

Officers 2002-2003

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SECTION ONE

Summary

Welcome to the new style BSA Annual Report. The Council's intention this year has been to prepare a shorter, more succinct document that gives members and others with an interest in the workings of the Association a concise description of the achievements of 2002 and aspirations for 2003.

The range of policy issues dealt with by the Association in 2002 was probably the widest ever. Changes in building society legislation, a new Banking Code, significantly enhanced anti-money laundering procedures, a flood of FSA consultation papers, the first judicial test of the powers of the Financial Ombudsman Service, a new framework for assessing capital adequacy, significant developments in the government's savings policy, the promotion of mutuality, major developments in corporate governance, corporate social responsibility, the introduction of mandatory payment of welfare benefits into bank and building society accounts, and financial inclusion, to name but a few.

While not complacent, the Association is, overall in a confident mood. 2002 saw further confirmation of the waning of carpetbagging influence and de-mutualisation sentiment. The very significant attempts that building societies have made to distinguish themselves from their plc competitors are making an increasing impact, both on member sentiment and market performance. Building societies' share of mortgage lending grew in 2002 while committed pro-mutual board-backed candidates received overwhelming support from their members at those societies experiencing contested board elections – and at those societies where there was no such contest.

Indeed, 2002 saw something of a renaissance in the mutual concept. The autumn saw four important developments that suggested that the perception of mutuals among key opinion performers was changing rapidly. Consider the following quote:

> "The mutual sector is vital in ensuring high standards, better delivery, equity and choice for consumers. Mutuals also provide a practical way of ensuring that citizens have rights to go with their responsibilities and are enabled to play an active role in the decisions that affect their lives."

> "Building societies are the smaller savers' best friend. Their branch-based products continue to outperform those of the high street and mortgage banks in all categories whilst their remote products are also superior, even to those offered by the supermarkets and remote banks."

Gary Boyles
Senior Research Fellow
International Institute of Banking and Financial Services
25 February 2002

The quote is all the more significant in that it was spoken by Gordon Brown MP, the Chancellor of the Exchequer (on 18 October 2002 at the Annual Dinner of the Normanton Co-operative Society). At the same time it was announced that Mr Brown had become a Patron of Mutuo – the trading name of Communicate Mutuality Limited, a think tank which brings together a range of organisations sympathetic to mutuals (including the Building Societies Association) to work for the greater benefit of all mutuals.

The second development was the passage of the Industrial and Provident Societies Act 2002. This back-bench Bill, piloted through the Commons by Gareth Thomas, Labour MP for Harrow West, makes it more difficult for carpetbaggers to force the conversion of Industrial and Provident Societies to plcs. The votes and turnouts required to convert I&Ps are now the same as for building societies; previously a simple majority was all that was required, with no minimum turnout. What is noticeable is that the Government played an encouraging role in the passage of the bill; it is well known that Private Members' Bills have little hope of getting through Parliament without Government support.

The third substantial development was the publication (in September 2002) by the Cabinet Office of *Private Action, Public Benefit*. The fundamental objective of this document was to consult on updating charity law, but it made interesting reading for building societies because it introduced the concept of protected mutuals, well known in mainland Europe. In France, for example, any mutual organisation that converts to a proprietary format has to ensure that none of the assets built up by the mutual are received by its members; rather, such assets must be given to a similar organisation remaining mutual, or to charity. The consultation paper proposed that such rules be introduced for some Industrial and Provident Societies (those that are run for the benefit of the community, the so-called "bencoms"), which according to the paper "should have the option of locking their assets irrevocably to certain social objectives". The paper notes, however, that "this is inappropriate for co-operatives, being purely member benefit organisations".

"When the Halifax Building Society became a bank, the chief executive was asked how it might affect his life. He said he would spend more time in the City of London. Yet another centre of local decision making was gone."

Paul Barker
Prospect
December 2002

The authors would also, presumably, believe it would be inappropriate for building societies, although they are not mentioned. However, it is clear that many co-operatives and building societies do bring with them community benefits, which possibly could be advanced by the idea now being put forward by the Government.

Finally, there was the proposed introduction of foundation hospitals, which according to Health Secretary, Alan Milburn MP, could well be organised along mutual lines, with patients being members of the mutual owning the hospitals.

In spite of these favourable developments, building societies do not feel that they can rest on their laurels; a key feature of the Association's work during the year was its commitment to informing itself and its members more about corporate social responsibility. A research project undertaken during the second half of the year on behalf of the Association, revealed a broad range of activities being undertaken by societies; a successful conference enabled many of the ideas currently being used by some societies to be spread more widely. Indeed, communication was something of a theme of the Association's work during 2002, with the successful formation of specialist panels designed to spread best practice on both member, and internal staff, communication. Already these panels have become fully integrated within the Association's work.

As ever, what many saw as the increasing burden of regulation represented a major part of the Association's work. The Association applauds the commitment of the Financial Services Authority to consult, even though the flow of consultation and discussion papers and responses, and subsequent new or amended rules and guidance at times appears to be of very large proportions. An important part of the Association's work is determining which of the FSA's activities impinge most upon building societies and ensuring that the appropriate response or alert to the sector is prepared.

With the banks, the building societies sector is one of the few in financial services still to be subject in respect of part of its business to a voluntary

"The carpetbagging threat to mutuals is lower now than it has been for the past decade. No society is considering conversion and there's more chance of finding Elvis on the moon than there is of getting a windfall in the next three years or so."

John Wriglesworth
The Sunday Times
15 December 2002

self-regulatory regime. During 2002 a new edition of the *Banking Code* was prepared (although it was not brought into effect until 1 March 2003). The revision to the Code represented a very successful outcome; this was the first time in five editions that an independent expert had reviewed the Code. Professor Elaine Kempson, the independent reviewer, consulted fully with all interested parties, made a range of recommendations to the sponsoring trade associations (the British Bankers' Association, the Association for Payment Clearing Services and the BSA) which were then, mostly, accepted. Nevertheless, the principal of self-regulation was retained with the three trade bodies retaining ultimate control over the contents of the Code.

Like building societies, the Association itself enjoyed a successful year. 2002 marked the first year of the Association's new relationship with the International Union for Housing Finance, the affairs of which it now administers. The Executive Committee of the International Union meeting in November was keen to extend the agreement indefinitely into the future, a proposal which the Association has accepted. The Association has also concluded a further two-year agreement to provide certain services to the Council of Mortgage Lenders, with which it shares its premises at 3 Savile Row. Many services have been shared since 1997, to the advantage of both organisations.

The Association also took steps to expand the number of associates to which it provides information. For many years, the Association had just six domestic associates, but by the end of 2002, the figure had risen to ten, and by early 2003 to twelve. All in all, these developments represented a considerable endorsement of the Association by range of extremely diverse organisations.

The Association entered 2003 in an optimistic frame of mind. At the beginning of the year the Council agreed a set of comprehensive prime policy objectives covering constitutional issues (including corporate governance), consumer affairs, money laundering, capital adequacy, financial inclusion, corporate social responsibility, and savings policy.

"The average net interest margin for the top 20 building societies was 1.22%, down from 1.26% last year and still significantly less than that for most of the mortgage banks."

KPMG Press Release
commenting on publication of Building Societies Database
3 September 2002

Secondary objectives covered a wide range of less significant, but still important issues. The Association will not be short of things to do in 2003!

> "Britain's biggest banks are offering the poorest value mortgages on the High Street... The [Moneyfacts] survey highlights the merits of building societies which outshone the big High Street banks - 14 out of the top 20 entries are mutuals while all of the bottom ten are banks."
>
> Daily Mail
> 18 December 2002

SECTION TWO

Policy Issues

As ever, the Association dealt with a wide range of policy issues during 2002. This section of the report briefly summarises some of the key points arising.

> "Building societies lead the mortgage pack this week with the best deals."
>
> Justin Harper
> Daily Mail
> 27 November 2002

The Banking Code

The Banking Code has been revised on a number of occasions since its introduction in 1991. The 2002 exercise, however, was unique in that an independent academic, Professor Elaine Kempson of the University of Bristol, who was selected after advertising and interview, undertook the review. After widespread consultation, Professor Kempson made a range of recommendations to the trade associations, which retain ultimate control of the contents of the Code. In the event, almost all of Professor Kempson's recommendations were implemented.

The key changes were -

(a) A new commitment to notify investors if rates of interest on savings accounts are reduced significantly in relation to bank base rates, and to give them the opportunity to move their savings notice and penalty free, if this occurred.

(b) A new commitment to speed up the process of transferring current accounts from one institution to another.

(c) A new commitment to show foreign exchange charges on credit card statements.

(d) A reordering of the Code, so that it is more logically arranged for the customers of those institutions that offer just one or two of the products covered by the Code. The new arrangement was particularly advantageous for those building societies that do not offer current accounts or personal loans and whose only product regulated by the Code is savings accounts.

The Association maintains close relations with the Banking Code Standards Board. The Association's Director-General is one of three industry representatives on the board of BCSB. (There are five independent directors and an independent chairman.) During the year, the BCSB successfully completed the integration of compliance assessment as a core activity; previously this activity had been outsourced. Many building societies enjoyed a reduction in subscriptions to the BCSB for 2002/03; further reductions are being implemented from April 2003.

Financial Ombudsman Service

Building societies have long supported the existence of an independent body to examine complaints against financial institutions, the solution to which cannot be agreed by the institution concerned and the customer.

There have, however, been concerns on the part of many institutions, including building societies, that the judgements made by the Financial Ombudsman Service on certain issues might, in effect, set new regulatory standards about which there had been much less consultation and discussion than is the case in relation to regulatory standards established by the Financial Services Authority. To their credit, both the FSA and the FOS were willing to discuss this issue with the BSA and a range of other trade bodies, and a mechanism was introduced towards the end of the year to deal with cases with so called "wider implications". It is not currently entirely clear how this mechanism will work; the Association nevertheless welcomes this development.

The decision by the High Court in a judicial review case brought by the Norwich & Peterborough Building Society against the FOS represented an important landmark in determining the precise powers of the FOS. The Ombudsman had found that Norwich & Peterborough had acted unfairly when setting its rates of interest on its tax exempt special savings accounts (Tessas) and individual savings accounts (ISAs). The society considered that there were strong grounds for its position and sought to have the decision overturned. It also took the view that, whilst the decision related to only one particular complaint, it would compensate all affected members if it was upheld. The only option was to apply for a

"With a growing number of new borrowers taking out MPPI, the market is worth about £500 million. Many big lenders charge about £6 for every £100 of monthly mortgage payments. Insurance brokers and building societies generally charge less."

Liz Philips
Daily Mail
27 November 2002

judicial review, and the standard of proof in such cases is extremely high. The society effectively had to establish that the Ombudsman had acted entirely irrationally in making his decision. The court found that the Ombudsman had exceeded his powers of interpretation in respect of the Banking Code; he had not, nevertheless, acted irrationally in reaching his decision.

Unfair Terms in Consumer Contracts Regulations

Building societies have become increasingly concerned in recent years about the potential difficulties in managing interest rate structures in the light of the decisions of the Financial Ombudsman Service, the provisions of the Banking Code and the provisions of the Unfair Terms in Consumer Contracts Regulations, which in some circumstances may not be entirely consistent, and can be very complex. Further regulatory guidance in this area had been expected during 2002. The lead qualifying body with the power to take an institution to court if it believes that the Regulations have been broken was the Office of Fair Trading but, from N2 (1 December 2001), the FSA took on this role. The FSA had indicated that it would publish a consultation paper during 2002 discussing its interpretation of the Regulations. However, at the time of writing this has not yet become available.

Universal Banking Services and Automated Credit Transfer

During the year the Government and banking industry made significant progress in preparing for the implementation of the Government's plan to transfer virtually all payments of welfare benefits from paper based to automated systems in the two years from April 2003. Through the provision of what became known as "Universal Banking Services" (UBS), welfare recipients will still be able to obtain their benefits at Post Offices. The Post Office itself will be offering an extremely simple account into which welfare payments can be paid and which individuals will be able to access by presenting a plastic card at any Post Office counter.

> "Moneyfacts looked at payouts for first TESSAs maturing now, assuming they were opened on 2 January 1997, the maximum amount was invested and all interest was compounded during the term. Of the 85 institutions surveyed, Norwich & Peterborough came out best with a £11,442 return."

Rupert Jones
Guardian
12 January 2002

The card will, however, have limited functionality and will not be able to be used, for example, in ATMs or to purchase goods in shops. The second component of UBS is the provision of basic bank accounts by a number of banks and the largest building society, Nationwide. Each of these institutions is committed to offering an account which offers basic money transmission facilities, access to ATMs and into which welfare benefits can be paid.

By April 2003, each of these institutions will have come to arrangements with the Post Office to enable account holders to withdraw funds in their account – including welfare payments – at Post Office counters.

Although most building societies will not be offering basic bank accounts it is likely that they will nevertheless be affected, possibly considerably, by these changes. Many people already have their benefits paid into building society saving accounts, an option that will be open to the 60% of welfare recipients currently using paper based systems at the Post Office. Accordingly, building societies are likely to experience more enquiries at branches and call centres about the suitability of their accounts for receiving welfare payments, increased traffic in branches and at ATMs, increased numbers of third parties collecting payments on behalf of, say, pensioners, more people who are disabled using their branches and greater difficulties in establishing the identity of individuals who may not have, for example, a driving licence or passport. On the other hand, many welfare recipients have a considerable need for financial services and building societies could well be in a position to offer such services to a new range of customers.

Financial Inclusion

By their nature, building societies are financially inclusive organisations, maintaining branch networks for example, where other institutions would have closed theirs and continuing to offer passbook savings accounts – a very clear and simple mechanism for enabling people to understand their financial position – years after many institutions withdrew the service.

> "Mutuals are one of the key elements of keeping the [financial services] market competitive."
>
> Sheila McKecknie
> Director, Consumers' Association
> Financial Times
> 6 July 2002

More specifically, building societies have also worked closely with other institutions in order to bring the benefits of their services to a wider public. In April 2002 the Association published *Models of Financial Inclusion – Co-operation between Financial Institutions and Housing Associations*, which described a range of schemes undertaken by building societies and some banks to work more closely with social housing landlords. It is estimated that at the end of 1999, 84% of those without any relationship with a financial institution were tenants of social landlords. It has been clear to the Association for some time that co-operation between financial institutions and such landlords represents an important mechanism to address the financial inclusion issue.

The Association has also worked with another BSA – the Basic Skills Agency – to improve the staff training available to deal with financial illiteracy. Whatever their skills in other fields, many customers find it difficult to understand financial concepts and some of the jargon used by financial institutions. The Association has participated in production of a new video with the Basic Skills Agency aimed at building society staff. The video helps staff identify customers with basic skills problems and strategies for helping them. The Yorkshire Building Society had piloted an early version of the video.

"Building societies are generally considered safe partly because they don't have any shareholders. The customers own the society, so the business should be run in your interests. No-one has lost money with a building society since 1945 ......"

Isabel Berwick
Your Money
Weekend FT
27/28 July 2002

Basel II

"Basel II" is a shorthand term representing the development of a revised international agreement designed to regulate the amount of capital that credit institutions should hold in their balance sheets to meet the various risks which they face in their business. Basel II applies to what are known as "internationally active" banks. However, a European Union Directive will apply the Basel principles to all credit institutions in Europe. The final version of the agreement has not yet been determined. However, some developments are clear. Most importantly for building societies, the capital weighting for most residential mortgages will fall from 50% to 40%, under what has been termed as the standardised approach to credit risk.

This will mean that in general terms, the amount of capital required by the FSA to be held by building societies in respect of the credit risks inherent in their mortgage books will be reduced. However, Basel II includes a new capital charge for operational risk, which will partly counteract the impact of this reduction. It is, of course, up to building societies – and other institutions – to decide whether or not they wish to follow through any reduction in overall capital requirements by reducing the amount of capital they actually hold. Currently, most building societies (and banks) hold well above the regulatory minima required.

Some large institutions are expected to move on to what Basel II calls the "internal ratings based" approach, which would enable them to determine their own rules for assessing their capital requirements for credit risk rather than sticking to a series of rules determined by regulators. These institutions will undertake a careful segmented analysis of the qualities of the assets which they hold, the probability of there being a default on these assets and the loss that might occur were default to take place. Some of the early calculations suggest that some institutions might have sharply reduced capital requirements, particularly for residential mortgages as a result of going through this process. It is not clear that these institutions will, as a result, reduce the actual capital which they hold. They will have a number of options; they could decide to use the excess capital to move into new markets, to invest in the existing mortgage business, to enhance returns to shareholders – in the case of mutual institutions, members, to acquire other institutions, to repay alternative forms of capital or to price more aggressively in the mortgage market.

It is too early to calculate how much spare capital institutions moving on to the IRB approach will have. This approach to credit risk represents just the first "Pillar" of the new Basel proposals. Pillar 2 requires firms to determine the additional capital needed to address business systems and controls, and other risks not adequately captured in the minimum capital requirements in Pillar 1. Pillar 2 also allows domestic regulators to increase capital requirements further for those areas, which they feel, have not been reflected in the institution's calculations. Regulators will also be concerned to ensure that the models developed by large

"Those with variable rate deals from major banks are being particularly badly stung, according to figures published this week by data analysts Moneyfacts....The survey casts building societies in a good light, with two-thirds of the top 10 places filled by the mutuals."

Daily Express
3 July 2002

institutions are not pro-cyclical – that is that they encourage low amounts of capital to be held against rapidly expanding loan books during periods of boom leaving institutions under-prepared for a recession, which would then be characterised by institutions building up capital and cutting back their lending in a way that might reinforce the cycle rather than ameliorate it.

At the time of writing, the Basel committees are examining the feedback of data from what is known as Quantitative Impact Study 3, to assess what the effect of the proposed new rules will be. Further significant developments are expected during 2003.

"Building societies dominate the field again with the best mortgage deals on the market for borrowers."

Daily Mail
17 July 2002

Corporate Governance

The question of how corporate bodies – mutuals, plcs, charities and voluntary bodies – govern themselves has been an area of intense debate and investigation. Since the beginning of the 1990s, building societies have been at the forefront of that debate. There were two key developments in 2002. The first was the implementation by Parliament of Regulations requiring quoted companies to hold an advisory vote at their AGMs on their directors' remuneration report.

The Regulations were introduced against a background of concern amongst many commentators about allegedly inflated salaries among senior executives of plcs. Sometimes such arrangements seemed to be accompanied by poor performance and paid in the form of share options, which had the impact of diluting shareholders' own interest in the organisation.

The Government did not feel that the problem, if it existed at all, was severe enough in the mutual sector to extend the legislation to organisations such as building societies. Nevertheless, the BSA set up a working group chaired by its incoming Chairman, Graham Stow, to examine the issues surrounding the disclosure of, and voting on, director remuneration. As a result, the Council of the Association now encourages societies to disclose information on directors' remuneration with their Summary Financial Statement (sent to all members) rather than just – as has been required for many years – in the full annual report and accounts. This is available to all members, but actually requested by few. In Spring 2002, seven societies – accounting for two-thirds of the total membership of all building societies, made such disclosures. Many more are expected to do so this year.

The Council of the Association did not feel it was appropriate to comment on whether societies should organise a vote, feeling this matter was best left to individual societies. Nevertheless, during 2003 it is anticipated that five societies will be holding such advisory votes.

The other key development in 2002 was the publication (actually in January 2003) of the Higgs Report on the role of non-executive directors of listed companies. Again, Higgs' recommendations were not directed to mutual organisations and, in some respects, mutuals were able to show that they were "ahead of the game". For example, the *Financial Times* said that the "key recommendation" of the Higgs Report was that non-executive directors should always be in the majority on a board – a situation pertaining in building societies and other mutuals for many years. Many building societies already advertise for directors as suggested by Higgs, and of course, undertake comprehensive training and induction, another of Higgs' recommendations. (Indeed, the Association runs induction seminars for new directors of building societies.) Some smaller building societies would, however, find it difficult to comply with the Higgs' suggestion that directors generally serve a maximum of six years, and it is not clear that this would be ideal for larger institutions. In a heavily regulated industry such as financial services, it often takes up to three years before a director is able to make a full contribution to the boardroom debate; the pool of available directors in a small community is often not sufficient to enable a society to dispense with the expertise which a director has gained during their first six years' service.

Corporate Social Responsibility

The concept of corporate social responsibility – the extent to which corporate organisations owe a responsibility to society as a whole, rather than just their shareholders (or members), and how this responsibility

> "Most building societies are better at the touchy-feely customer service stuff than other financial companies. Partly it's because they still operate more of a branch-based structure compared to their banking counterparts. But also because the de-mutualisation wave of the late 1990s forced many of them to reconsider how they could give better value to their members. Generally, I think they've succeeded."

Nic Cicutti
FTYourMoney Newsletter
13 May 2002

might be discharged, if it exists – has attracted significant interest over the pass few years. Parliamentary debates, suggestions of legislation, European Commission interest, the activities of pressure groups and institutions' own thoughts on taking this issue forward, have all encouraged institutions to consider carefully their relationship with society at large.

Mutual organisations are natural leaders in the CSR debate. During 2002, the Association decided to discover more about the subject and the approach taken by its members in this area. It commissioned the Smart Company to undertake research to find out more details on building societies' CSR activity, and to write a report to enable best practice to be spread and to promote building society achievements to the outside world. Paper and telephone questionnaire-based research, a conference and a publication fulfilled these objectives towards the end of the year. The research measured the extent of building society activity in relation to the workplace, the environment, the communities in which they were located and member relations. Perhaps not surprisingly, it was found that building societies' strongest contribution was in the field of community relations, most building societies feeling they have a strong affinity to their locality. The research also reported on building societies' success in introducing appropriate employment and work based practices to guard against ethnic, racial, religious or sexual discrimination and their approach to environmental sustainability – results that were extremely supportive of the Association's initial belief that building societies undertook significant activity in this area. This work is being extended in 2003.

"Because this country has a proud tradition of mutuality, it is better placed to take forward the corporate social responsibility agenda."

Baroness Greengross
speaking at a BSA seminar on CSR
21 November 2002

Savings Policy

There was significant progress in the Government's savings policy during 2002. An important development was the publication of the Sandler report – a report prepared by the former Chief Executive of Lloyd's of London, Ron Sandler, at the request of the Treasury. Sandler noted that the economic signals that typically made markets efficient were absent in that for regulated financial products. He pointed out that those able to save only small amounts found it difficult to access the appropriate level of advice. The regulatory requirements to "know the customer" and offer "suitable advice" required a significant investment of time on the part of advisors, which potential low-income customers could not pay for, either directly through fees or through commission generated on the relatively low level of savings they were able to undertake.

Sandler recommended that a range of strictly defined, heavily regulated products be introduced that would be exempt from the FSA's normal conduct of business regulations. Sandler argued that this approach would enable sales to be made to those able to afford to save relatively little and that those individuals would be subject to less risk (than if they purchased mainstream products) as a result of purchasing products in what became known as the "Sandler suite". Controversially, he also suggested that there be a cap on the charges that investment firms would be able to levy on those products. The Association accepted an invitation to sit on an advisory committee established by the Treasury to consider product design, and early in 2003 the Treasury issued a consultation paper covering this issue. At the time of writing the Association was still considering its response.

"Savers have paid a massive price for receiving insurance company windfalls over the past four years. Money Mail research reveals that insurers which have given up their mutual status have cut their with-profits endowment payouts by far more than those who remain mutual."

Tony Hazell
Daily Mail
13 March 2002

There was also considerable policy development in 2002 in respect of the Child Trust Fund (CTF) and Savings Gateway. Building societies had been enthusiastic supporters of the Child Trust Fund concept, as originally proposed by the Government. It had been proposed that the Government would make a contribution into a savings account established for every child when it was born, followed by further contributions at the ages of five, 11 and 16. Parents, grandparents and friends of the family could also make payments into the account, which would mature when the child was 18. In a consultation paper issued in the spring of 2002 a key issue was whether Child Trust Funds could be offered by those financial institutions which felt that they had the competence to run the scheme or, rather, whether the Government should issue licenses to just five or ten providers to enable licensees to have a closer relationship with the Government (and thus perhaps run the scheme more effectively) than would be possible with a much wider range of institutions involved. Most trade associations, including the BSA, opposed the second suggestion. The Association was pleased with the Government's announcement made in November that all institutions would be able to offer CTFs if they wished. The Treasury consultation paper on the Sandler proposals (see above) questioned whether CTFs ought to be part of the simplified product range envisaged in the Sandler Report.

The Government's other savings initiative of recent years has been the Savings Gateway. This is designed for very low-income savers, perhaps saving for the first time. Under the proposed scheme, which began to be piloted in 2002, the Government contributes an amount equal to that saved by the investor, up to a limit of £25 per month or £1,000 (£375 in the pilot). A bank was given sole opportunity for working with the Government on the pilot schemes operated in four different parts of the country. However, building societies hope that they will be able to participate in the full scheme, if the Government decides, on the basis of the pilot, to introduce this.

Finally in the savings area, there has been some criticism since 1999 about the complexity of the ISA regulations. Some investors have mistakenly opened a combination of mini and maxi ISAs that has left them, unwittingly, in a position that they may have to pay tax on savings they thought would grow tax-free. During 2002 the Inland Revenue consulted on regulations that would slightly ameliorate this problem by enabling institutions to "repair" certain invalid ISAs. The Association welcomed this development, provided full details to members, and also organised a workshop on the subject.

Prevention of Money Laundering

Over the last few years concern about money laundering – the transfer of funds illegally obtained or destined for use for illegal purposes, such as terrorism - has become a key concern of authorities worldwide. Building societies have been keen to support regulators' efforts in this area. During the year, significant work was undertaken in response to the importance attached by regulators to financial institutions properly checking the identity of their existing customers – especially those who

> "While no institution is perfect, customer satisfaction surveys tend to put building societies above most other financial institutions."
>
> Nic Cicutti
> Financial Adviser
> 16 May 2002

opened accounts before the extension of stringent "Know Your Customer" regulations in the late 1990s. This became known as the "current customer review" and will result in building societies having to re-establish the identity of some of their longer-standing customers during 2003 and 2004.

Discussions continue with the FSA on the series of filters that will be introduced to ensure that those customers who present no threat of money laundering are not inconvenienced by the review. This process also enables the review to be brought down to a manageable size on the part of the institutions concerned. The Association is now working with other trade bodies, the FSA and HM Treasury on the best way to communicate with customers on this programme

During the year, the Association agreed – with a range of other trade associations – to a British Bankers' Association proposal to establish a company limited by guarantee to prepare, revise and publish the Joint Money Laundering Steering Group Guidance Notes.

Finally, the Association provided a range of information to its members during the year on the implementation of the Proceeds of Crime Act 2002, Part 7 of which changed significantly the anti-money laundering responsibilities of financial institutions.

Financial Services Authority Consultations

During 2002 the Financial Services Authority issued 45 consultation papers (of which nearly half were either wholly or partly relevant to building societies) and eight discussion papers (of which three were directly relevant to building societies). Many of those, and earlier such papers, were followed up during 2002 by response and feedback documents, and various amendments and additions were made to the FSA Handbook of rules and guidance under the Financial Services and Markets Act 2000.

During the year the Association responded to many of the FSA's consultations, including those on liquidity risk systems and controls, operational risk systems and controls, individual capital adequacy

> "If you float a mutual, whether it is well run or stuffy and inefficient, savings rates go down and mortgage rates go up. This has been demonstrated repeatedly."
>
> Mail on Sunday
> 24 March 2002

standards, the new regulatory reporting environment, disclosure of statutory status, guidance on use of the FSA's powers under the Unfair Terms in Consumer Contracts Regulations, and FSA fees.

The Association aims to draw attention to the main implications for building societies of relevant material as soon as it becomes available on the FSA website. Where appropriate, societies are encouraged to provide comments to the Association so that these can be taken into account in preparing a response on behalf of the sector. A fourth edition of the Association's *BSA Guide to the FSA Handbook* was issued in February, and regularly supplemented during the year.

Two useful meetings were held during the year between the Association's office-holders and senior staff, and senior FSA officials from Deposit Takers Division. Members of the Secretariat maintained frequent contact with relevant FSA policy staff, and took part in numerous meetings with the FSA.

"Nationwide customers could be £1,300 a year worse off if it finally becomes a bank, according to research by the *Sunday Mirror*.....we have discovered the biggest losers will be Nationwide's 10 million members - just like other customers with former building societies like the Abbey National and Halifax when they lost their mutual status and became banks."

Sunday Mirror
14 April 2002

SECTION THREE

External Relations

As ever, the Association pursued a pro-active external relations policy during 2002, seeking to present the Association's and building societies' view on the range of policy issues so far discussed in this report. The Association seeks to inform and influence commentators in Government, Parliament, the media, the City, academia and consultancies as well as those in the regulatory community.

"TESSA savers with leading banks have generally been paid much lower rates than they would have earned with building societies, and it is still possible to claim compensation from many."

Sylvia Morris
Daily Mail
23 January 2002

Political Programme

The Association's political programme is based on the work of the All Party Building Societies and Financial Mutuals Group. This group, chaired by Andy Love, Labour MP for Edmonton, was again active in 2002, holding meetings that were addressed by Philip Williamson, Chief Executive of Nationwide, John Tiner, Managing Director of the FSA, Will Paxton of the Institute for Public Policy Research, and John Reeve, Chief Executive of Family Assurance Friendly Society. The Association generally finds all political parties sympathetic to mutual ideals, for reasons outlined in the introduction to this report.

The Association was particularly active at the political party conferences in 2002. Fringe meetings were held at the Labour Conference – to discuss democracy in mutuals – and at the Liberal Democrat Conference - to discuss the expansion of mutual principles in the provision of public services. Both events were well attended; the Association was also represented at the Conservative Party Conference.

Annual Lecture

The Annual Lecture has also become a well-established feature of the Association's calendar. First held in 1997, the Association has an enviable record of attracting top-class presenters. 2002 was no exception with a stimulating address given by Phillip Middleton, Head of Retail Banking at Ernst & Young. He suggested that building societies and other mutuals might have to return to their radical past in order to guarantee a successful future. Over 100 guests attended the lecture.

Annual Lunch

Similarly, the Annual Lunch continues to be a popular event, on this occasion attended by over 200 people. In 2002 the guest speaker was John Tiner, one of the FSA's Managing Directors, who responded to an address given by the Chairman of the Association.

Annual Conference

The Annual Conference was, as ever, held in the spring, on this occasion in the first week of May in Bournemouth. The 2002 event followed the innovative procedures in 2001 in which a range of coincident sub-plenary sessions were introduced giving all delegates a wide choice as to the type of programme they wished to individually pursue during the conference. Feedback from the event was extremely positive.

International Relations

The Association, as noted in previous *Annual Reports*, has always been keen to understand the development of housing finance systems in other parts of the world and to contribute to international discussions. In December 2001, the Association took over the administration of the International Union for Housing Finance (in exchange for a fee) and Adrian Coles, the Association's Director-General became the Union's part-time Secretary General.

The first year of the relationship proved successful with a revamping of the Union's website, the introduction of a new format newsletter and the negotiation of a range of discounts for members from institutions keen to attract customers to their conferences and seminars.

The Association remains active in the European Mortgage Federation; Adrian Coles has been a member of the Executive Committee of that body for some years. The Federation provides a unique insight into the development of European policy in some of the key areas affecting building societies' performance.

"Building societies top ISA annual league table"

Headline in The Guardian
15 April 2002

Shelter

The Association has had a long relationship with Shelter, the national campaign for the homeless. Shelter is the primary charity associated with the 2003 Flora London Marathon and the Association was honoured to be invited by Shelter to be its first trade association partner in this event and to provide runners to participate in the Marathon. 95 building society employees volunteered to take part, committing to dedicating their sponsorship money to Shelter. The actual number of runners is likely to be a little less than this, as some potential competitors are forced out through injury or other problems during their training. Nevertheless, a significant building society presence is anticipated when the Marathon is run on 13 April 2003.

Communications

Building societies have, of course, always been keen to communicate, in the best way possible, with their members and with their staff. During 2002 the Association formed two new working groups to help societies spread best practice and to gain new ideas from each other. The Member Communications Forum allows representatives of societies to share ideas on how best to communicate with members – through member councils, focus groups, member newsletters, the internet, market research or suggestion schemes, for example. Similarly, societies have been keen to improve the effectiveness of their communication with staff and a similar Internal Communications Forum was established to share good practice in this area. Both new groups were greeted enthusiastically by societies. They both built on the work of the well-established Public Relations Forum, which brings together staff in societies with responsibility for media relations.

www.bsa.org.uk

The Association continued to develop its website during 2002. The site was frequently mentioned in the press, and described as "excellent" in *The Daily Telegraph* in December. The site contains a full list of BSA members and associates, recent press releases and newsletters, a range of frequently asked questions, the Association's consumer leaflets, statistics

"As you might expect, it is building societies that dominate the higher payers on maturing TESSAs…For follow on ISAs, the strength of building societies is even clearer. Not a single bank makes it into the top 10 and the best high street bank is Barclays in 26th place."

Jess Hinings
Money Management
March 2002

on individual societies and the industry as a whole, outside views on the development of societies, full annual conference details, BSA policy papers and links to related organisations. The site also provides links to the Association's Dormant Accounts Scheme, and details of how to trace societies that have merged or changed their names in recent years.

"Millions of customers are counting the cost of windfall bribes handed out by mortgage lenders and insurers which floated on the Stock Exchange. We're now paying for them in dearer mortgages, lower returns on our savings and poorer service . . .The reason for this is simple. Banks, mortgage lenders and insurers have to pay dividends to their shareholders. Mutuals, which are owned by their customers do not."

"It is no accident that firms which floated on the stock exchange often dominate the best-buy tables for mortgages and savings. But as customers are increasingly finding, they all come with a price. These deals are offered to a minority of customers, often at the expense of the rest. And, as many regular Mirror Money readers are aware, many so-called bargains have penalties and catches hidden away in the small print."

"Nationwide, Britain's biggest building society has survived repeated attempts by carpetbaggers to force it to become a bank. That's been good for its 10,500,000 customers who have consistently enjoyed cheaper mortgages and better savings rates"

John Husband
The Mirror
15 May 2002

SECTION FOUR

Other Issues

Associates

The Association has recently made available its Circulars and other publications to non-building society institutions – domestic associates - that have an interest in developments in building societies, and are sympathetic to their aims and objectives. Such institutions might include professional advisers, other suppliers of goods or services to building societies, or institutions with a similar mutual structure such as the friendly societies and mutual life assurance companies. At the beginning of 2002, the Association had six associates; four new institutions joined in the second half of 2003, and two more early in 2003, meaning that at the time of writing the Association had twelve associates – five mutual insurance companies, NFU Mutual, Liverpool Victoria, Police Mutual, Royal London and Wesleyan; three firms of chartered accountants, Ernst & Young, KPMG and PricewaterhouseCoopers; three firms of solicitors – Addleshaw Booth, Thomas Eggar and Wragge & Co and one consultant and systems company, Unisys. More institutions have showed expressions of interest in accessing the Association's expertise and a further growth in associateship is anticipated.

Building Societies Trust

Building Societies Trust is a charity associated with the building society industry, which seeks to make small grants to institutions concerned with savings, housing, home ownership and building society matters generally. The Trust supports the provision of a library on building society matters and during 2002 also made grants to Shelter, the Money Advice Trust and the Personal Finance Education Group (pfeg). The Trust formerly made grants using the capital gains made on its equity investments. In current stock market conditions such a policy is much more difficult, and grant-giving has been reduced so that it is now in line with the dividend income received by the Trust.

The Directors of the Trust are Martin Ritchley, Chief Executive of Coventry Building Society and a member of the BSA's Council, and Geoffrey Fitchew, a former First Commissioner of the Building Societies Commission. Its Chairman, Graham Kentfield, is a former Chief Cashier of the Bank of England. The affairs of the Trust are administered by BSA staff.

"The steepest falls in endowment values have taken place at the insurance companies which demutualised: payback time for the windfall winners has come swiftly...In a candid admission, Norwich Union senior actuary David Ridington, said this week: 'The deal on demutualisation was that existing policyholders got part of the "estate". If you get it one way, you are going to lose it another way.'"

The Guardian
16 March 2002

Conferences and Seminars

The Association ran 21 conferences or seminars as well as its Annual Conference during 2002, compared to just nine in the previous year. The subjects covered included Basel II and capital adequacy, financial crime prevention, the role of audit committees, the Euro, the implications of the Sandler report, accounting issues, treasury management, e-commerce, constitutional issues, employment law, corporate social responsibility, and operational risk. Seminars were also held for newly appointed, and experienced directors, and for new joiners to the sector.

The Association has a productive relationship with a range of other organisations which are willing to bring their expertise to the Association in particular areas. Accordingly, seminars and conferences were offered on subjects in which the Secretariat had no or little expertise; prices are generally kept extremely low.

Relations with the Council of Mortgage Lenders

The Association has enjoyed a close and productive relationship with the CML since 1997. It is clearly advantageous to be able to share the 3 Savile Row premises, plus a range of administrative and office services, with the CML; sharing saves costs to both organisations. At the end of 2002, a new two-year deal was agreed taking the relationship forward to the end of 2004.

The Financial Position

During the year the Association made a deficit of around £30, 000, small in the context of a total income of over £3 million. Full details are circulated to members in a separate document.

Library and Information Services

The BSA has continued to provide a free information and library service. In 2002 the section dealt with around 9,000 enquiries on a broad range of housing, mortgage and savings related topics. In addition to maintaining a comprehensive archive of BSA and CML material the library subscribes to 200 journals, holds over 3000 reports and has access to a growing range of online resources.

Physical Security

2002 saw a continuation of a downward trend in robberies against building societies with a 33% decrease over 2001. However, the retail banking sector as a whole saw an increase of 2%. This reflects a shift from opportunist robberies to more organised crimes and a focus by armed robbers on high volume targets. Improvements in cash management systems, security equipment and staff training have been very successful in reducing losses in building societies.

Although the robbery situation improved, societies were increasingly concerned about incidents of verbal abuse, harassment or physical assault against staff. During 2002, the Association worked with a group of banks and building societies on the preparation of guidance in this area.

Scottish police forces have always been very proactive in their work with banks and building societies and several societies attended meetings with the Scottish police.

Regional Security Group meetings for all societies took place twice during the year and were extremely well attended. Subjects covered included alarm systems, cash management and crisis management.

The BSA works very closely with the British Bankers' Association Security Liaison Group and there is a great deal of liaison and information exchange, including joint representation on issues such as alarms policy, as well as joint working groups on specific issues.

Membership of the Council

Membership of the Association's Council changed only a little during the year. In March John Mitchell resigned on his retirement as Chief Executive of the Principality Building Society. John had been in post since 1986 and had seen the Principality grow to become Wales' largest

"The debate about whether organisations should demutualise was overtaken by the question of how much money individual members would receive, regardless or whether such a move was to the benefit of the society.
Almost all the arguments used by the managements of the organisations that demutualised are now either bankrupt or do not apply."

Andrew Love
Labour and Co-op MP for Edmonton
House of Commons
19 April 2002

independent financial institution. He was able to bring the distinctive view of the Principality (in both senses of the word) to the Council table, adding greatly to the Council's deliberations. Peter Richardson, Chief Executive of the Derbyshire Building Society, succeeded Mr Mitchell.

In November, Ian Kitchen retired as Chief Executive of the Cumberland Building Society after many years of distinguished service. He simultaneously resigned from the Council of the Association. Mr Kitchen's dry humour, knowledgeable input and iconoclastic approach will be much missed. As Mr Kitchen's term of office concluded in any case at the 2003 AGM, the Council decided to make no special arrangements to fill the vacancy ahead of that date.

Staff

The senior staff of the Association changed in just one respect during 2002. Regrettably, Jennifer Holloway, External Affairs Manager, left in February. However, the Association's loss was Skipton Building Society's gain, as Jennifer moved to take up a similar position in that organisation.

In April, Rachel Blackmore joined as External Affairs Manager with a strong background in both financial services and public affairs. Rachel rapidly settled in and made a significant contribution to the Association's work during the year.

Early in 2003 Mark Bratt left the Association. His input into the revision of the Banking Code, and steady hand on the various money laundering issues that arose recently made him a valuable, and now much missed, member of staff.

The Council pays tribute to the staff of the Association for the comprehensive service provided to members, and their professional and dedicated approach to serving societies at a time of unprecedented regulatory upheaval.

"There simply isn't an appetite for more demutualisations. Nor should there be. The banking sector hardly needs yet more new entrants. Moreover, Nationwide's prompt decision last month to compensate mortgage borrowers who regulators ruled had been overcharged shows why mutuality is important. Organisations owned by their members - rather than shareholders motivated by profit - are more likely to behave in the interests of customers."

David Prosser
Sunday Express
31 March 2002

SECTION FIVE

Directory

THE COUNCIL

(As at 1 January 2003)

Chairman

Graham Stow (Britannia)

Deputy Chairman

John Goodfellow (Skipton)

National

John Goodfellow (Skipton)

Andrew Messenger (West Bromwich)

John Parker (Stroud & Swindon)

Peter Richardson (Derbyshire)

Martin Ritchley (Coventry)

Nominated

David Anderson (Yorkshire)

Graham Stow (Britannia)

Philip Williamson (Nationwide)

Regional

Barry Hunt (Midlands & West) (Hinckley & Rugby)

Bob Jackson (Metropolitan) (Cambridge)

Gordon Robinson (Northern) (Mercantile)

THE SECRETARIAT

(As at 1 March 2003)

Director-General

Adrian Coles

External Affairs

External Affairs Manager: Rachel Blackmore

Financial Policy

Head of Financial Policy: Christopher French

Legal and Practice

Head of Legal Services: Chris Lawrenson

Policy Adviser: Ruth Lamb

Library and Information

Information Services Manager: Simon Rex

Personnel, Finance and Administration

Head of Personnel, Finance and Administration: Jane Jones

Premises and Facilities Manager: Paul Bealing

Personnel Manager: Louise Thornbury

MEMBERS OF THE ASSOCIATION

(As at 1 March 2003)

Barnsley
Bath Investment
Beverley
Britannia
Buckinghamshire
Cambridge
Catholic
Century
Chelsea
Chesham
Cheshire
Chorley & District, The
City of Derry
Clay Cross
Coventry
Cumberland
Darlington
Derbyshire
Dudley
Dunfermline
Earl Shilton
Ecology, The
Furness
Hanley Economic
Harpenden
Hinckley & Rugby
Holmesdale
Ipswich
Kent Reliance
Lambeth
Leeds & Holbeck
Leek United
Loughborough
Manchester
Mansfield, The
Market Harborough
Marsden
Melton Mowbray
Mercantile
Monmouthshire
National Counties
Nationwide
Newbury
Newcastle
Norwich & Peterborough
Nottingham
Penrith
Portman
Principality
Progressive
Saffron Walden Herts & Essex
Scarborough
Scottish
Shepshed
Skipton
Stafford Railway, The
Staffordshire
Stroud & Swindon
Swansea
Teachers'
Tipton & Coseley
Universal
Vernon
West Bromwich
Yorkshire

ASSOCIATES OF THE ASSOCIATION

(As at 1 March 2003)

Addleshaw Booth & Co

Ernst & Young LLP

KPMG

Liverpool Victoria Friendly Society

NFU Mutual Insurance Society

Police Mutual Insurance Society

PricewaterhouseCoopers

The Royal London Mutual Insurance Society

Thomas Eggar

Unisys

Wesleyan Assurance Society

Wragge & Co

The Building Societies Association
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BUILDING SOCIETIES ASSOCIATION