

## CHAIRMAN'S ADDRESS

### Text of a Speech by David Smith, Chairman, The Building Societies Association at the BSA Annual Conference, Edinburgh, 8 June 2000

#### INTRODUCTION

Nearing the end of my year in office, about which I may say something later in this Conference, and with the benefit of considerable experience, if not wisdom, in this industry, I think that I have a perspective on which to base what follows.

The past year has been, for building societies, one of successful response to challenge. Business challenge - none amongst us would argue that competitive conditions are becoming any easier - and constitutional challenge, where small groups of individuals motivated by greed continued their attempts to destroy the sector.

Why do I say that building societies have been successful in meeting that challenge? In business terms, the information is there for everyone to see. Since the conversions of mid-1997, building societies have consistently undertaken lending and attracted savings deposits at well above their historic market share. It was a building society that led the defence of customers' rights to access their savings through cash dispensers without paying a fee. It is building societies more generally that have shown that it is possible to continue meeting the need for the delivery of branch-based financial services.

On the constitutional side, we saw the magnificent victory achieved by the staff, the management and the board of Leek United Building Society, and I would like to publicly acknowledge the tremendous achievement of Leek United, and in particular its Chief Executive, at this our first AGM since the Leek's special general meeting in early December last year. It was noteworthy also that the members of that Society rejected the quick buck in favour of continuing the tangible benefits of mutuality.

I would like to look at some of these issues in greater depth, beginning with the constitutional issue. However, let us not forget that the vast majority of people are not interested in the constitution of building societies or the various rules and regulations governing conversion to plc status. What interests consumers is the value for money they get from their dealings with a building society, and that value includes the level of service, rates of interest, product design and product availability, in other words, the business case for mutuality. There is a danger - and I don't think we have fallen into the trap - of becoming too obsessed by constitutional issues and taking our eye off what really matters to our members. I will return to these in a few moments.

#### CONSTITUTIONAL ISSUES

I make, however, no apology for beginning with the constitutional point, although I hope that, one day, one of my successors in office might be able to address you only on the business issues of the day!

There is no such thing as democracy pure and simple. Every democratic system has to be surrounded and policed by a set of rules, which can have a fundamental impact on the outcome of a vote. Compare, for example, the first-past-the-post and proportional representation methods of electing governments. Under the first-past-the-post system the current Government had a majority of close to 180 seats over all other parties in Parliament; on a PR system, however, it would not have won a majority, gathering 43% of the votes cast at the 1997 General Election, interestingly, fewer than John Major in 1992. And since we are in Edinburgh, where the Scottish Parliament is headquartered although not yet in its permanent abode, it is interesting to note that proportional representation was used, and that, as a result, the Labour Party did not win a controlling majority, and formed a coalition with the Liberal Democrats. Interestingly, with the First Minister, Donald Dewar, now convalescing after a serious operation, his deputy, effectively in charge of the administration, is Jim Wallace of the Lib Dems. Translate that back to Westminster, and you might try to think of Charles Kennedy standing in for Tony Blair whilst he enjoyed what he assures us was not paternity leave!

Let me emphasise that I mention this electoral system, not as a political point - a similar observation could have been made about Mrs Thatcher's famous electoral victories in the 1980s. I make the point to emphasise that electoral rules matter and will always influence the outcome of a vote or election.

This is especially the case in the building society demutualisation debate. In July 1999 the Treasury Select Committee proposed some significant changes to the electoral rules covering this issue because, in the view of that important group of MPs (drawn from all political parties), the existing rules were not even-handed as between investing members of building societies and borrowing members. You will all recall that the Treasury Select Committee recommended that, in essence, the voting rights of borrowers be made equal to those of investors, so that a turnout of 50%, with a 75% majority of those voting, was required in each constituency in order to pass a conversion resolution. The Select Committee also recommended that these thresholds apply to a resolution relating to conversion put forward by members, as well as a formal conversion resolution proposed by a board of directors.

In the event, the Government rejected the Treasury Select Committee's advice. It did, however, introduce orders that had the effect of sharply increasing the number of members required to requisition a special general meeting, to propose a motion at an annual general meeting, or to nominate a director. These changes were welcome and I would like to thank the Treasury, and the Economic Secretary herself, Melanie Johnson, for enabling these changes to go through.

They do not provide the complete answer to the problem of small groups of short term, low value investors manipulating the rules in order to obtain a significant payout which they have done nothing to earn, but they are a move in the right direction. It is interesting to note that had the new rules relating to numbers been in place at the time of the submission of the Bradford & Bingley resolution, that resolution would not have been put, supported as it was by just 70 members. Had the changes to voting regulations recommended by the Treasury Select Committee been in place, the decision by 60% of Bradford & Bingley's borrowers who voted, to vote against demutualisation would have prevented any further steps being taken to turn Bradford & Bingley into a bank. Nevertheless, I wish Bradford & Bingley well, whatever the outcome of its formal vote later this year to turn into a plc.

Building societies and their longer term genuine members have, of course, not been slow to take constitutional action themselves, rather than waiting for the legislators to take it on their behalf. Forty-two societies now have charitable assignment schemes in place, including all of the largest. It is now virtually impossible to carpetbag a society that has any chance of converting. Secondly, members of 41 societies have voted in favour of rule changes which mean that a 75% majority would be required to pass a members resolution relating to conversion, rather than the original 50%.

Let those who run the various anti-mutual web sites be clear on one thing; it is getting harder and harder to convert a building society against the will of its long term members, against the will of the borrowers and against the will of local communities.

## WHY MUTUALITY?

But let us not forget that we defend mutuality not for mutuality's sake. We don't argue for the retention of our mutual status just because we always have been mutual, and we would like that state of affairs to continue into the future. No, the only point of mutuality is if it gives consumers a better deal in every sense of the word than would be available elsewhere. How does that better deal manifest itself? There are, I believe, three key principles to which mutual building societies should adhere -

- (a) Building societies can adopt keener pricing because they do not need to pay a dividend to shareholders.
- (b) Building societies can be, and have to be, more consumer responsive because they are accountable to their customers rather than to external shareholders.
- (c) Building societies can take a longer term view because they are not subject to the short term pressures of the City.

How do these principles manifest themselves in current building society activity, especially in light of the most likely consumer question relating to mutuality - that is, "what's in it for me?".

(i) Better Pricing

Let's look at the first point, that building societies can offer better pricing because they do not need to pay dividends to shareholders. There is no doubt that there is the potential in the building society model to offer a better pricing deal to customers. The accounts of the mortgage banks that were once building societies make it quite clear that payment of dividends adds about 40% to the total costs of running the organisation; that is, management costs plus dividends are 40% higher than management costs alone. Building societies have a natural low cost advantage and I am pleased to say that they virtually all use it. There is, however, no room for complacency. A mutual institution which wastes the mutual dividend on inefficiency, on higher costs not reflecting high levels of service, or in unwise lending decisions is squandering its potential advantage. In those circumstances, mutuality is not worth defending. Inefficient mutuals tarnish the name of mutuals in general, while offering their customers no discernible benefit. Having said that, however, let me emphasise that in general terms building societies operate on much narrower margins than their plc competitors. This is reflected in both lower standard variable mortgage rates for existing customers and, as evidenced by their strong market share over the last three years, competitive deals for new customers.

(ii) Responsive to their customers

My second principle of mutuality was that building societies are, and have no choice but to be, more responsive to customer needs. This partly follows on from my previous point. It is notable that in examining how best to use the mutual dividend available to them, building societies have not used all the benefit available in the form of attractions for new customers, but have offered significant discounts to existing customers. A dozen or so societies offer further discounts after the customer has been with them for say three or five years. Only one plc offers such a benefit and that becomes available only after seven years.

Let me give you another example by posing a question. If the chairman and chief executive of large banks were subject to three-yearly election by customers, would they close branches and introduce cash machine charges in the way that we have seen in recent months? If they did, would they have been re-elected? Mutuality - accountability to the customer rather than to the shareholder - gives institutions an entirely different ethical and commercial approach to doing business. Of course, no building society can say that it will never close branches. It would be ridiculous to keep open a branch that no customer ever enters. However, it is notable that the number of building society branches has remained broadly stable over the last three years. In the rush to take advantage of the undoubted benefits of Internet and telephone banking, we must not forget that large numbers of customers are reassured by the presence of physical branches, real people and, most importantly, personal advice.

Maintenance of branch outlets is not an end in itself; it is a way of bringing the building society service to where the customers want it. It is notable, however, that research undertaken in the Centre for Urban and Regional Development studies at the University of Newcastle has shown that building societies are opening branches in the inner urban and rural areas that have tended to lose the branches of the mortgage banks. In their very impressive paper the academics from Newcastle showed conclusively that building societies were playing a major role in combating financial exclusion, not through the invention of new schemes, which sometimes seem to be accompanied by press releases that have had a greater creative input than the schemes themselves, but through the provision of a service which remains reliable and available on a day by day basis year after year.

Branches are not the only example of building societies' commitment to a high level of service; look at an issue I touched on a few moments ago - cash machine charges. It was a bank that initially proposed breaking the long standing agreement that customers of other institutions would not be charged for using that institution's own cash machine. It was a building society that fought for the principle (and was willing to go to court to establish it) that customers should be able to have fee free access to their cash, whichever cash dispenser they use. The vast majority of building society cash dispensers had always been free to use. Furthermore, the vast majority of building society customers with ATM cards could use other institutions machines without any charge. By the beginning of May this year, building societies were in a position to say that there were no charges for using either their cash dispensers, or their cards

at other institutions' ATMs. Thanks are due to one or two other institutions which backed the building society case, including the Co-operative Bank whose Chief Executive will be speaking at this conference later today.

The building society example, is now being followed, albeit with some considerable delay, by at least one of the mortgage banks. That recent announcement is one of the best examples of the point that building societies have been making for some considerable time - that their activities, and in particular their approach to pricing their financial products, puts a cap on the prices that other institutions are able to charge, in other words, by their very presence they are a vital competitive force.

(iii) Long Term Presence

My third principle of mutuality was that mutuals are there for the long term. Indeed, it is notable that financial services mutuals have historically been strongest in those areas where customers need a long term relationship with the institution - notably mortgage lending and life insurance. With short term contracts one can afford to take the chance that the plc's natural and proper accountability to the shareholder might result in a poorer service to the customer. If that is the case the customer can move elsewhere. A long term contract, however, involves a greater degree of trust, that the institution will continue to look after the customer long after the acquisition of the business has boosted the first year's sales figures. As I said earlier, it is notable that it is building societies rather than plcs that have led the way in reduced prices for customers, that some institutions have tended to regard - it seems now mistakenly - as locked in. Building savings, and building homes with the aid of a mortgage loan is a long term business. A mutual is in a much better position to understand and meet long term aspirations than a plc. How many of the new institutions coming into the market will still be in place in 25 years time? Will Egg have cracked? Will Virgin have been violated? Will institutions remain in Cahoots with their shareholders rather than their customers? What IF today's best deal turns out to be tomorrow's ball and chain? One has only to look at what happened to the new entrants of the mortgage market in the last set of good times, the late 1980s. How many of them retained their enthusiasm?

As market research over the years has established clearly, building societies are liked and trusted by their members. Indeed we all like to be liked, but in the context of financial relationships being trusted is the big thing. But with that trust comes responsibilities. Building societies as mutual institutions, accountable to and responsible for the implementation of the dreams of their customers, must not abuse that trust.

Over the last few minutes I have outlined my three pledges of mutuality - a well priced deal, a better service deal and a longer term deal for the customer. I would suggest to every building society in this audience that they should consider and introduce their own series of messages to their customers. These messages should be easily memorable by the staff, easily understood by the customers and actually mean something in terms of price or service delivery. Using my own Society, the Dunfermline, as an example, which I hope you don't mind, one of our key messages is to maximise member value. You will recognise that as not dissimilar to the objectives of plcs where they have a duty to maximise shareholder value. It seemed to us that there was no better, or indeed shorter phrase which encapsulated the three principles of mutuality.

Mutuals must make themselves relevant to their customers before they complain to the Government that the electoral rules about which I spoke earlier are not fair, however strong their case in this respect might be.

In framing those messages I would like to recommend every society to use a technique which I think was pioneered by the Nationwide but which I know is used now by quite a few societies, including my own. I am talking about the road show concept, where senior executives, including the chief executive and sometimes accompanied by non-executive directors, go out and meet their members, not only in the branches but in specially convened evening meetings. There is no better way to formulate your three messages on the advantages of doing business with your society than by testing them out in open meeting with a group of interested members. Focus groups were instrumental in enabling Tony Blair and his colleagues to understand what ordinary people felt about the political process and the policies offered by new Labour. They can be equally useful to building society chief executives wanting to know what their customers think of them, how to maintain their current high market shares and how to deliver the benefits of mutuality without compromising their

service. The events that my own society has held have shown that members interested enough in your organisation to spend an evening with you are not, as they say, “off the wall”; they have sensible and constructive comments to make. Usually these customers are right, and they have a point of view that is more than defensible. Finally, they don’t believe in you just because you say you are a mutual, run in their interest. I go back to my earlier point - you have to show - no, to prove - that mutual status delivers something to customers that is not available elsewhere.

Building societies are well on the way to demonstrating that not only do they deserve to retain their place in the financial services market, but that it is essential that they do so - for the sake of choice, diversity, efficiency and the long term health of the financial system. Despite recent successes building societies must not get complacent. Customer needs are constantly changing. Even if building societies, with some justification, think they have got it right now, that is not a case for suggesting they have it right for tomorrow.

## REGULATION

I would like to spend just a few moments looking at the regulatory framework which building societies and other financial institutions face. It is now three years since the announcement was made that nine different regulators would be merged into what has now been named the Financial Services Authority. We, of course, very much look forward to listening to Michael Foot’s account of how that plan is progressing when he speaks tomorrow. However, it is notable that since the announcement of the creation of the FSA five further regulators have either been created or announced - the Mortgage Code Compliance Board, the Banking Code Standards Board, the revamped General Insurance Standards Council, PayCom - the regulator proposed by Cruickshank to look over money transmission - and the Pensions, Protection and Investments Accreditation Board designed to improve the standards in the life insurance industry.

On current trends, it shouldn’t be too long before we have created another four regulators so as to enable us to merge them all together and create FSA mark two! I jest of course. There are very good reasons for retaining the self-regulatory approach implicit in all of these organisations’ activities, rather than putting them under the statutory regulator. I for one, for example, would not favour a requirement to conduct a full fact find before somebody is allowed to open a no notice savings account. There may be more complex arguments relating to mortgages and precisely what and what not within that sector should be each side of the statutory/voluntary dividing line. On balance, however, I believe that voluntary regulators have the power to do good.

What is important for all of these regulators, both statutory and voluntary, in just the same way as I have explained for building societies, is that they focus on outcomes rather than process and that sufficient attention is paid to the result of regulatory activity. For example, it is clear that in recent years the concentration on the prevention of money laundering has been one (and I stress just one) factor in creating financial exclusion. Similarly, the regulation of APRs has been a factor in creating confusion in consumers’ minds about the true cost of mortgages, but hopefully this has now been rectified. The requirement to provide information to customers on financial products has arguably also failed in its intention, as the information, required by regulators to be produced, is now so voluminous that there is a risk customers read none of it at all, and are less well informed than if just half the amount of information had been published, but that consumers actually read it.

My point is that regulation must be as focused on customer needs as mutual institutions are. As I have noted, some regulatory approaches have been detrimental to the consumer. The new series of regulators must ensure that this does not continue to be the case in the future. So far, I am optimistic that we are moving in the right direction in this area.

## CONCLUSION

Today’s financial services market is very different from that of twenty-odd years ago, when I came into the building society sector. Then we had a cartel, building society legislation essentially unchanged since 1874, very little competition and, I believe, with hindsight a lack of regard for the customer. Building societies competed amongst themselves by opening as many branches as they possibly could in as short a period of time as possible.

Today things are entirely different. If one thinks how things have changed over the last twenty years one has an idea, but I suspect only that, of what might happen over the next twenty years.

We know that in the future customers will be more individualistic, less settled in emotional, social and economic relationships, more willing to move on and look for new experiences, more likely to have breaks in their income and to move from career to career.

Mutual institutions have a huge role in such a society. As incomes become more variable over time and less certain, the need for a few thousand pounds rainy day money, easily accessible from a deposit account becomes ever more apparent. Similarly, as society becomes more atomistic, the concept of membership, of people clubbing together to help each other out at times of adversity becomes more appropriate.

Mutual building societies have tremendous opportunities. If they take those opportunities their future is assured.