

WHY BUILDING SOCIETIES REALLY MATTER

Presentation by
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to the
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AGENDA

- Overview of UK mutuals
- Overview of building societies
- Demutualisation – causes and consequences
- Redefinition of mutuality by building societies
- Commercial pressures



OVERVIEW OF UK FINANCIAL MUTUALS

- 60 building societies – assets £305 billion
- 90 mutual insurance companies – assets £182 billion, of which -
 - 78 friendly societies – assets £16 billion
 - 567 credit unions – assets c£420 million
 - 40 (approx) retail co-operative societies – turnover £12 billion
 - Co-operative Bank – deposits £15.1 billion
 - Co-operative Insurance Society – investment and insurance liabilities £19.3 billion



OVERVIEW OF BUILDING SOCIETIES

- 60 building societies – very large to very small
- 48,000 staff (full and part-time)
- 2,147 branches
- 2,662 ATMs
- 21 million investing members
- 2.8 million borrowers
- £305 billion assets
- 70% retail funded
- 90% residential mortgage lending
- Around £1 billion pre-tax profit
- 20% of outstanding mortgages and savings



BUILDING SOCIETY LEGISLATION

- Own legislation; not Companies Act
- At least 50% funded from members; in effect, maximum 50% wholesale funded
- 75% of lending on residential property
- Few powers constraints
- Members are individuals with savings or mortgage accounts; other customers are not members



CAUSES OF DEMUTUALISATION

- General intensification of competition
 - Loss of the building society mortgage monopoly in the early 1980s - entry of banks into the mortgage market
 - End of the BSA "cartel" - the Recommended Rate System - in the early 1980s
- Privatisations gave the example
- Philosophical mood-change in the Thatcher era from collective forms of ownership (eg mutuals) to individual forms of ownership (plc)
- Diversification strategy of some societies
- Building Societies Act 1986 provided mechanism for demutualisation
- Insurers' need for capital



"BENEFITS" OF DEMUTUALISATION

■ Members

- Windfalls -
 - Abbey National, 1989, £130 per member
 - Halifax and others 1997, £2,000 per member
 - Bradford & Bingley 2000, £850 per member
- Total in 1997 - £36 billion in shares and cash; equivalent to 6% of consumers' expenditure

■ Staff

- Executive pay increased

■ Institutions

- Access to capital (but not a main motivator for BS)
- Better able to participate in restructuring
- Initially, wider powers as banks



EXECUTIVE PAY & DEMUTUALISATION

“We examined the relation between corporate performance and executive compensation of converted and mutual building societies and determinants of compensation over the period. Several findings emerge –

- First, average compensation of chief executives of converted building societies increased three folds in seven years while their counterparts in mutual societies benefited only by a modest increase.
- Second, whilst there is no significant difference in the performance of these two groups, the executives of converted societies received significantly higher compensation. Their total benefit increased significantly after the conversion.



EXECUTIVE PAY & DEMUTUALISATION

- Third, the study confirms a significant difference in the determinant of compensation in converted and mutual societies.
- Finally, neither the corporate performance nor the size explains the compensation received by the executives of converted societies. However, a positive relation between corporate performance and executives' compensation is observed in the cases of remaining mutual building societies.
- Overall, the possibility that the flotation of the mutual societies was inspired by the private interests of executives cannot be ruled out."

Abstract of Building Societies' Demutualization and Managerial Private Interest, by Radha K Shiwakoti, Lecturer in Accounting, Kent Business School, University of Kent, 10 July 2005



WIDER EFFECTS OF DEMUTUALISATION

- Branch closures
- Restructuring of the sector
- Wider margins and dividend payments
- Change of culture



BRANCH CLOSURES 1995-2000

	Number of branches		% Reduction
	1995	2000	
Main banks	9,922	8,904	10.3
Converted building societies	3,699	2,806	24.1
Continuing building societies	2,192	2,140	2.4



BRANCH CLOSURES 2000-2005

	2000	2005	% Change
All banks	11,758	10,759	-8.5
Building societies	2,139	2,147	+0.4

Excluding the Bristol and West branches acquired by Britannia in 2005, the number of building society branches reduced by 4.2% and the number of bank branches reduced by 7.5%



BRANCH CLOSURES – UNIVERSITY OF NOTTINGHAM

One interpretation of the faster rate of closure [in banks than in building societies] is that public companies are under more pressure to make cost savings as they are driven by the necessity of producing value for shareholders “such pressures, some of the respondents argued, led to banks closing not merely branches that were losing money, but also branches that were profitable, *but just not profitable enough* [authors’ italics].”



BRANCH CLOSURES – UNIVERSITY OF NOTTINGHAM

In contrast, as one organisation [it is not clear from the report whether this is a bank or a building Society] is quoted as saying “the general view among building societies is that the branch network is valuable for member relations... customers value the personal contact. That’s not universally so, but it tends to be the case that building societies... keep their branches open for both financial and non financial reasons.”

*University of Nottingham – The Changing Geography of British Bank and Building Society Branch Networks 1995-2003
(Andrew Leyshon, Paola Signoretta and Shaun French)*



RESTRUCTURING OF THE SECTOR

- Most life insurance demutualisations (10 out of 12) have involved mutuals giving up their independence as well as their mutuality
- Only three of the ten building societies to convert have not been involved in significant corporate restructuring
- Restructuring among building societies has slowed. Fewer mergers immediately after the demutualisations. Acceleration now?



WIDER MARGINS AND DIVIDEND PAYMENTS

- On average management expenses plus dividend payments are 30-35% higher than management expenses alone, in the converted institutions. This is the cost increase resulting from demutualisation
- Dividends equal around 35-55% of profits; dividends are not re-invested in the business
- Margin comparisons are increasingly difficult because of different types of business, with different levels of risk. Typical building society margin in 2005 around 90 basis points



CHANGE OF CULTURE

“We believe very strongly that retaining the Woolwich’s culture and values is important for ensuring that the Woolwich’s high standards of customer service are maintained and for safeguarding the future of its management and employees.”

Woolwich Building Society, Transfer Document, 1997



CHANGE OF CULTURE

Commenting on the departure of 25% of the group's Senior managers during and since the conversion process, John Stewart, Group Chief Executive, said

“Culture has been the biggest change at the Woolwich over the last year to 18 months. A building society culture is wonderful in terms of customer care, but it isn't particularly good at identifying where the value is in the business. We need a different type of person in the future.”

Financial Times, 19 February 1998



EARLY DEFENSIVE MEASURES

- Membership perceived as offering “free money”
- Vast numbers of account openings at remaining societies
- Increased minimums for account opening
- Locals only
- From 1997 charitable assignment – most societies by 2000
- New legislation, removing most constraints
- Longer-term: promoting mutuality with new ideas



MUTUALITY in BUILDING SOCIETIES – BASIC MESSAGES

- No shareholders, no dividends
- Lower margins
- Better products
- Consistent value
- Retain branches
- Regional and organisational diversity
- Competitive impact - BS activity constrains the banks
- Member engagement



SIX PILLARS OF MUTUALITY

- Democratic engagement with members
- Mutual financial indicators
- Member friendly practices
- Existing members are as important as new members
- Corporate Social Responsibility
- A mutual culture



DEMOCRATIC ENGAGEMENT WITH MEMBERS

- High voting turnout at AGMs
- Advertising for directors
- Board fees and salaries: information and voting
- Chief executive road shows; focus groups; members panels; member council
- Member communications manager
- Member newsletters
- Good corporate governance generally



MEASURING PERFORMANCE

- Growth - assets and mortgages
- Profitability - optimise, not maximise
- Margin - the lower the better?
- Costs - minimise? Cost/asset or cost/income?
- Capital



COMMERCIAL PRESSURES

Income, Expenditure and Surplus 2001-2005

Per cent of mean assets

	Net Interest Income	Other Income	Provisions and losses	Management expenses	Corporation Tax	Retained Surplus
2001	1.42	0.34	(0.00)	(1.06)	(0.21)	0.50
2002	1.26	0.40	(0.08)	(1.04)	(0.15)	0.39
2003	1.24	0.37	(0.09)	(1.04)	(0.14)	0.34
2004	1.13	0.43	(0.05)	(1.02)	(0.14)	0.36
2005	1.09	0.40	(0.08)	(0.94)	(0.14)	0.33

Source: FSA

Note: Figures are financial year aggregates for all building society groups



NARROWING MARGINS: OPTIONS

- Widen margin and do less business
- Travel along the risk curve to expand the margin
 - Higher income multiples/LTV on otherwise prime
 - Sub prime
 - Self-cert
 - Buy-to-let
 - Commercial
- Control funding costs
- Expand other income
 - Diversify into new areas
 - Diversify within financial services



NARROWING MARGINS: OPTIONS

Cont'd

- Concentrate on what you're good at, eg
 - Origination – passing on leads, or more
 - Administration of others' mortgages and deposits
 - Funding – use others to originate
- Cut, or share, costs, or go it alone?
- Accept reduced profits?



THE MARGIN – THE KEY INDICATOR?

“It is imperative to remember that the one and only true measure of the benefits which apply to all members, is through an organisation’s interest rate margin.”

Skipton Building Society Annual Report 2001
(and subsequently)



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