Can Mutuals Find a Role?

by David Carlisle

INTRODUCTION

"Over the last five years, building societies, cooperative societies, friendly societies and many other mutuals have given a great deal of thought to the essential nature of their mutuality. Is an organization's mutual status merely a constitutional form without any particular behavioral connotations, or does the mutual corporate form mean that an organization has different values, different relationships with its customers, and a different approach to doing business compared to an ordinary company?"

So begins a recent article by Adrian Coles, the director-general of the Building Societies Association in the United Kingdom. Mutuals in the U.K., and in the rest of the Anglo-Saxon world, have been forced to contemplate their essential characteristics in recent years as complex economic and social forces have threatened to consign them to history, apparently without relevance in the 21st century. Thirty years ago the majority of residential mortgage lending in the U.K., South Africa, Australia, and New Zealand was undertaken by mutual institutions. Such bodies also probably undertook around half of all lending in the United States. In South Africa there are now no building societies; in Australia only a handful, and some of these, although called building societies, have a proprietary structure. In the U.S. there are perhaps some 600 mutuals left, although the largest would not make the top 20 on any measurement of size of activity in the mortgage market.

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The U.K. was behind the trend, and by mid-1995 only one institution, Abbey National, had converted to plc and bank status. However, by the end of 2000, eight further societies, representing over two-thirds of the assets of the sector, had converted either to free-standing public limited companies (PLCs) quoted on the London Stock Exchange or to wholly-owned subsidiaries of already existing PLCs. There was pressure on other societies to convert, and some have had to win votes of their members to retain their mutual status.

Mortgage lending has not been the only financial market associated with demutualization. Similar changes have taken place in the life insurance sector on both sides of the Atlantic.

This article looks at the attractions of converting to the proprietary form, examining examples from around the world. It then concentrates on the position now faced by U.K. mutuals, and the arguments deployed within the sector to defend and promote what they believe to be their distinctive contribution to the market.

THE TREND TO DEMUTUALIZE

Proponents of demutualization have two extremely strong arguments working in their favor. Quoted companies can more easily do two things that mutuals find difficult—raise capital and participate in industry consolidation. One of the key factors in the demutualization of the U.S. thrift industry was the fact that much of its capital had been wiped out in the interest rate spike of 1979–1982. (Thrifts raised funds at variable rates at no or short notice, but lent at fixed rates over 25 years. They were singularly ill equipped to cope with high and variable interest rates.)

In South Africa and Australia mutuals were probably more equally motivated by both factors, plus a third that applied in these markets, but less so in the U.K. and U.S.—the mutual regulatory charter was more restrictive than that available to stockholder-owned institutions. Sometimes regulatory structures move more slowly than market developments, and this can lead institutions

to find their way around regulatory obstacles rather like a river finding a new path when its original flow is blocked. Once demutualized, South African building societies were able to participate in the rapid consolidation of the banking sector.

In the U.K., Abbey National felt it needed to convert:

- To escape restrictive provisions in the U.K.'s building society regulation—finally removed in 1997.
- To raise capital. It was the only one of the U.K. building societies to raise new capital at the time of its conversion.
- To be in a position to participate in a consolidation process, which it felt was on the way. This proved far-sighted when it was able to use its paper—in a sense, print its own money—to purchase another demutualizing building society, National & Provincial, in 1996, against some reported competition from a number of mutual building societies. Abbey National also used its share-issuing capacity to expand its presence in the life assurance and protection markets, and now has three wholly-owned insurance subsidiaries.

Interestingly, one of the two large building society demutualizations in the Republic of Ireland, that of Irish Permanent, was soon followed by a merger between it and Irish Life.

Slightly different arguments have been deployed in France, an obviously non-Anglo-Saxon country where there has been an interesting experiment in partial demutualization. In France, 25% of the central Credit Agricole (one of the largest banks in the world) has been floated in a sort of half-way solution to some of these issues. The shares give CA a currency with which to purchase other institutions. At the same time, however, CA remains 75% owned by the 46 regional CAs, while owning in turn 25% of those institutions. The remaining 75% of the regional CAs are owned by the hundreds of local banks in the group, which are owned collectively by their members.

Back in the U.K., the participation of former building societies in the consolidation process was marked by the acquisition, two years after its flotation, of the former fourth largest U.K. society, Woolwich, by the banking giant, Barclays, and by the merger of Halifax, formerly the biggest U.K. society, with Bank of Scotland, to form HBOS PLC. Again these moves would have been extremely difficult, if not impossible, had the Halifax and Woolwich remained mutuals. Arguably, this merger has intensified competitive pressures in the U.K. banking market, to the benefit of consumers, by creating a new "fifth force" to challenge the dominance of the four main institutions (Barclays, Royal Bank of Scotland (with its subsidiary National Westminster), Lloyds TSB and HSBC), which for many years have controlled large proportions of personal and small business banking.

The acquisition of N&P highlighted a further point that has characterized discussion of demutualization in the U.K. context—often to the amazement of overseas observers. N&P reportedly examined the possibility of merging with another building society, but felt this was not appropriate because of a fourth (U.K.) argument in favor of demutualization—the release of value to those who happened to be members of the mutual at the point of conversion.

When Abbey National converted in 1989, members of the society—its depositors and borrowers— were each given shares that at the point of conversion were valued at £130. By 1995, when Cheltenham & Gloucester became a subsidiary of Lloyds Bank (now Lloyds TSB following a further merger), it divided the £1.8 billion acquisition cost among the approximately million members more or less equally—giving each member just under £2,000 in compensation for the loss of ownership rights that few knew they had. In subsequent months, as press rumors of further demutualizations grew, the remaining building societies faced queues of people seeking to open accounts in the hope of obtaining similar windfalls. Such people became known as "carpetbaggers," originally an American Civil War term used to describe victorious northerners who moved south seeking land, carrying their possessions in their "carpetbags."

The phenomenon of carpetbagging, in its modern U.K. context, was aided by a particular characteristic of building societies in the U.K.: one member, one vote. The senior managers of demutualizing building societies in the U.K. had to ensure that as many members as possible voted for conversion at the special general meeting that U.K. law obliges them to hold in order to proceed with such a proposal. U.K. law also requires borrowers and savers to both agree to the conversion, voting in separate constituencies. For savers there must be a 50% turnout, and 75% of those voting must vote in favor for the conversion process to go ahead. For borrowers there is no quorum and a majority vote in favor is all that is required. Given these rules, there is an incentive to managers seeking to convert to ensure that the distribution of shares (on a flotation) or cash (on a take-over) is as equal as possible, irrespective of the size or length of the relationship between the member and the building society. These factors are not recognized in the voting arrangements in U.K. building societies.

Over the last few years, the U.K.'s building societies have faced attempts by "carpetbaggers" to force them to convert. Carpetbagger activists have stood for election to

become members of building society boards, although none have been successful, and some have tried to organize member votes on the specific question of conversion. Nationwide Building Society, the largest, won such a vote by a slim margin in 1998. A much smaller society, Leek United, won a vote by a 75%/25% margin in 1999. Bradford & Bingley converted in 2000, after its members voted in 1999 to become a bank against the advice of its board. Outside the building society sector, the board of Europe's biggest mutual insurer, Standard Life, saw its members accept its advice to remain mutual in a highly publicized vote in 2000.

Interestingly, carpetbagging has not been a phenomenon among European mutuals, for example the cooperative and agricultural banks that hold strong positions in Germany, France and Holland. Typically, in these countries it is not possible to distribute value to existing members on a conversion. The so-called "French lock" law means that in France any value arising from a conversion or winding-up of a mutual or cooperative institution must either go to charity or another mutual; individual gain is prohibited. French observers look on in amazement at what they believe to be the manifest unfairness of the U.K. system.

The Case for Conversion Summarized

In summary, therefore, conversion from mutual to stockholder form is usually motivated by one of four factors:

- A desire or need to raise capital.
- A desire or need to participate in merger, acquisition or industry consolidation.
- Regulatory arbitrage and a desire to take advantage of perceived more favorable regulatory conditions available to a proprietary company.
- A desire to release value to members.

Given these arguments, how does an institution make an argument for remaining mutual? The rest of this article examines the progress made by the U.K.'s 65 remaining building societies. Those institutions currently have assets of £175 billion, around 20% of the residential mortgage and deposit savings markets, 2,100 branches and 35,000 staff. As the first paragraph of this article points out, mutuals have had to think carefully about their role and purpose in the new world that has grown up around them since the mid-1990s.

Staying Mutual

The first imperative for the U.K.'s societies was to remove the incentive to open new accounts by those whose only interest in opening such an account was to be able to vote for the demutualization of the society, and then pick up a windfall.

Most of the U.K.'s societies, following an example set by Nationwide in November 1997, now have a term in their savings account opening literature that commits a saver to assign to charity any windfall they might obtain as a result of demutualization. For a few societies this assignment is in perpetuity. Most, however, require a five-year assignment, which means that savers would be entitled to retain their windfalls had they been members for five years at the time of conversion. This move has enabled societies to operate normally; at times in the mid-1990s massive queues of people seeking to open accounts stretched outside many building society branches.

Once the situation had thus been stabilized it was necessary to examine the nature of mutual institutions in the way indicated by Coles' comment at the beginning of this article. Coles has developed a series of six criteria for mutuals to distinguish themselves from stock institutions.

Firstly, Coles suggests that there is now much greater interest in democratic engagement with members.

Ten years ago, no more than 1% or 2% of the members of a building society took part in its annual general meeting (AGM). Last year the average voting turn-out (obviously mostly by post) was 22%. Building societies and other mutuals have invested considerably in clearer annual reports and AGM documentation, reply paid envelopes and independent scrutineers, all designed to boost interest in voting and to give confidence in the results. A number of building societies now broadcast their annual general meetings on the Internet. There is external advertising for directors, so as to displace any illusions about "old boy networks." Road shows now enable senior executives to meet members in a relaxed atmosphere to discuss the way in which a society is developing. (Interestingly, this reflects what has long been the case in the French Credit Agricole, where senior managers of the regional CAs attend each of the AGMs of the local CAs to answer questions and participate in discussion. The regional CAs typically have around 50 local institutions in their area.) Building society members' newsletters are now much more common and more attractively produced. None of this can happen in the PLC sector, says Coles, because customers there are not members. Rather the management is ultimately responsible to shareholders, and must act in their interests, rather than in the interest of the customers.

Second, for Coles, there is now greater interest in delivering the financial benefits of an institution's mutual status to its members.

In the late 1980s, some building societies were as profit oriented as the major banks. This has now changed. While the banks,

rightly, boast how wide their profit margins are, building societies are fighting as hard as they can to reduce theirs', so as to take as little as possible from the customer to cover the processes of financial intermediation that they undertake. This means lower mortgage rates and higher savings rates. The corollary of access to capital—identified above as one of the key advantages of demutualization—is the requirement to pay dividends to shareholders. Comparison of converted U.K. building societies and the remaining mutuals shows that dividend payments add about 35% to the management costs of an institution. Mutuals avoid this cost and, if they are run efficiently—a crucial condition, now increasingly the case although not always so in the past—are able to pass on the benefit to their members.

In the insurance industry, research undertaken by the International Cooperative and Mutual Insurers Federation across 11 European countries shows higher payouts on long-term savings plans held with mutuals compared to converted insurance companies. Because they are not profit maximizers, it is argued that mutuals can take an entirely different approach to their business than PLCs.

Coles' third point covers attitudes to customers.

Typically, it is argued that mutuals offer a friendlier approach to their customers than do PLCs. For example, in the five years to 2000, building societies closed 2.4% of their branches, while the converted mortgage banks that used to be building societies closed ten times as many—23.9% to be precise. Some branch closures are probably inevitable, given increasing use of the Internet, automated teller machines, telephone, post and intermediaries such as mortgage brokers. Nevertheless, in the U.K. the closure of bank (and the few building society) branches, especially in rural and in inner urban areas, has been emotive and controversial, and frequently the subject of front-page press attention. Also, it is notable that building societies are more likely to offer charge-free savings and mortgage accounts, individual notification of interest rate changes, and fewer confusing changes in their line-up of accounts. Many consumer satisfaction surveys show mutuals in a better light than PLCs.

Coles' fourth point covers treating existing members fairly, rather than taking advantage of the existing members to subsidize the acquisition of new members.

In the U.K. the market for new mortgage borrowers is very competitive. Institutions will typically offer "teaser" rates for the first year or two of a mortgage—a rate heavily discounted from the standard rate charged by the institution. Of course, such rates are subsidized by existing customers paying slightly higher rates on their loans. This practice leads to problems for mutuals which, philosophically, should be giving their existing members whatever benefits are available from their mutual status, rather than offering the greatest benefit to new, possibly short-term, members. A number of building societies have tried to overcome this by offering discounts to customers who have been with them for say three or five years, or introducing pricing strategies that offer the same deals to new and existing members. There is widespread agreement that current pricing in the U.K. mortgage market is not sustainable and that change is coming.

It is not yet clear whether some brave pricing decisions by mutual institutions will carry the day, in the face of other institutions prepared to use their existing customers to subsidize new ones in the fight for market share in the market for new loans. Currently, a typical U.K. lender will find that about 40% of its new business is re-mortgage loans attracted from other institutions. It is not clear how long a market so heavily reliant on institutions swapping customers with each other can survive.

Coles' fifth point covers involvement with the community.

Because many mutual institutions are based in, and are creatures of, their local communities, they are necessarily closer to those communities and more involved in their activities than remote institutions based in, say, the City of London, and influenced by the international capital markets. Typically, mutuals will sponsor the local soccer team, various school activities, and the work of local theaters and horticultural societies, among many others, making themselves relevant to the whole community. Stockholder-owned banks clearly also have corporate social responsibility programs, but may find it difficult to understand local communities in quite the same way as institutions actually based in those communities.

The sixth pillar relates to culture.

When the Woolwich Building Society converted to a PLC in the mid-1990s, John Stewart, its chief executive and now deputy chief executive of Barclays Bank, said: "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."

There are clearly differences in the culture of stockholder and mutuals; neither one nor the other is good or bad – it all depends on what the institution is trying to do.

CONCLUSION

There is no definitive answer to whether the stockholder or PLC approach to business is

"best." Clearly, one approach will better suit some institutions while the other will benefit others. Each approach has its own advantages and disadvantages. In the author's view economic and social systems benefit from diversity and choice. The conversion of some financial institutions to PLC status has probably increased competitive pressures, and enabled some useful rationalization to occur. On the other hand, the retention of significant mutual institutions ensures a customer-focused approach, local decision-making, and cheaper financial products, if mutuals use their dividend advantage properly.