

## A Case for Conversion

*This article, prepared by Keith Brading, is based on material provided by the Board of Abbey National Building Society.*

In the debate over whether building societies can provide a better service on their present mutual basis or by converting themselves into public limited companies (plc's), the Board of the Abbey National Building Society has decided that its members' interests will be best served by conversion to plc status. Four considerations lie at the heart of this decision:--

1. Whether, under modern conditions, mutuality provides an appropriate constitutional form for efficient operation;
2. The effect of the Building Societies Act 1986 upon institutions operating in a deregulated market;
3. Building societies' vulnerability to environmental shifts;
4. The need for freedom in determining the direction and pace of future development.

It is submitted that an examination of each of these considerations leads to the conclusion that members'/customers' interests will be better served by changing from a mutual to a plc constitution.

### **1. Mutuality still an Appropriate Form?**

A mutual organisation is owned by its members, each of whom has one vote. Historically, the only real significance of this vote has for long been that it could be used in the election of directors and, more recently, to vote on changes resulting from the Building Societies Act.

In practice, very few members choose to exercise their right to vote and the reality of mutual building societies is that in no sense has ownership been equivalent to control. Building societies have effectively been run by self-perpetuating boards of directors whose success cannot be attributed to any significant influence from their memberships.

### *Mutuality and PLC – the Differences*

In their capacity as owners of the business, members could expect to benefit only in the unlikely event of liquidation; and in practice the rights and benefits of members bring them little or no tangible value. Under the terms of the

Building Societies Act 1986 the only practical way that members can receive some benefit from ownership is through conversion to plc. Shareholders in a plc, in addition to their participation in ownership and voting, in proportion to their holdings, are able to participate directly in profits distributed by way of dividends and also to benefit from future growth of the organisation. The Act opens up the opportunity of giving members free shares and priority application rights (or cash to members not qualified to vote on the conversion issue) and therefore provides a means of realising the benefit of ownership to existing members, without affecting their position as customers.

The mutuality constitution originated with small local terminating building societies i.e whose existence terminated upon completion of the houses which in those early days societies were formed to build. It is the Abbey National's view that this is no longer appropriate for an organisation of its size and complexity operating in an increasingly competitive financial services environment. True mutuality in building societies ended, anyway, when terminating societies were superseded by permanent societies in which borrowing members and investing members had directly opposing interests; the former wanting low interest rates and the latter high savings rates.

#### *The Preference of the Customer?*

A corporate constitution is not an end in itself but a means of providing a competitive product range and service standards. Research has shown that for the vast majority of personal customers the constitution of the institution from which they buy their products is not an issue. Their decision is dominated by the perceived quality of the product. If a building society fails to compete on these terms, the fact that it is a mutual will not persuade consumers to accept an inferior service. It is the ability to compete and not mutuality *per se* that is the key to ensuring the best service for customers.

In the United Kingdom mutual life insurance offices are successful because they have the ability to compete, and many Co-operative retailers are unsuccessful because they have not.

## **2. The 1986 Act – An Anachronism**

The Building Society Act 1986 is in conflict with the general trend of UK, and also global, financial deregulation. By placing specific restraints upon one group in the financial services sector it undermines the principle of competitive neutrality. In short, it creates an anachronism in the financial system by making building societies extremely vulnerable to inroads on their business by banks, insurers and new lenders. The latter are not similarly constrained and therefore have the necessary freedom to adapt to wider external shifts and to change the markets in which they operate.

The 1986 Act is anachronistic in three senses. First, it goes against the trend in legislation for financial services by regulating a group of institutions rather than all institutions which operate in a given market.

Secondly it maintains a regulatory approach which is prescriptive rather than allowing discretion once minimum prudential requirements have been met. The 1986 Act broadens the scope of activity that building societies may undertake, but it still prescribes the scope. This contrasts with the supervisory approach of the Bank of England which allows institutions to manage the development of their future activities provided certain minimum prudential and financial standards are met.

Thirdly, the Building Societies Act is also an anachronism in the context of 1992 and the internal European market. The proposed Second Banking Co-ordination Directive is aimed at the creation of a single European banking market allowing any credit institution incorporated in a Community member state to provide services throughout the E.C. However, the 1986 Act effectively prevents building societies from taking full advantage of the single European market because of the restrictions it imposes on societies' overseas operations.

#### *Dependence on Future Legislation*

The Building Societies Act 1986 is not only anachronistic in a number of respects but it also forces societies which do not convert to rely on legislators to modify the regulatory regime in the future. Recently building societies had to persuade the regulators to bring forward a possibility of relaxation built into the 1986 Act by raising the wholesale funding limit from 20% to 40% of total funds. This has taken time. We have also witnessed other modifications required to the Act. In Abbey National's view the situation is clearly untenable for societies which thus have to compete on the basis of the uncertain and bureaucratic process of convincing regulators of their case. Furthermore, the difficulty in designing a long term regulatory framework for a specific group of organisations is indicative of the Act's inappropriateness in the present largely deregulated financial services sector.

Building societies now work within a framework which is almost as fully extended as it can be under the Act. The competitive framework can in future only be significantly extended further through primary legislation. This is an uncertain and time consuming process which can only be an obstacle to the ability of building societies to initiate competitive responses. Societies have already found that the confines of the Act seriously restrict their ability to operate in the mortgage market and it is Abbey National's view that its restrictions will undermine the ability of large societies to compete effectively in the future.

### **3. Vulnerability to Environmental Shifts**

In the recent past building societies lost a significant share of total mortgage business. Between 1970 and 1987 their share of net new mortgage advances fell from 87.3% of the total market, to 51.5%. This mainly arose because building societies could not take advantage – as the banks were able to – of the ability to raise wholesale funds which were available at prices more favourable than those of retail funds. The banks' drive into the mortgage market was joined by new breeds of mortgage lending institutions who were able to exploit the weaker competitive position of building societies. Building societies' market share plummeted 22% between 1986 and 1987 alone.

Fundamental changes are still at work, with a new emphasis on the personal financial customer by British and foreign banks as well as "new entrants". These trends will result in the traditional markets of building societies becoming competitive in ways that cannot be predicted on the basis of their "cosy" past experiences. For example, few would have foreseen retailers (Littlewoods, Marks and Spencer, and a number of others) moving into the financial services sphere as they are doing. With their highly-developed distribution systems and level of customer contact we are likely to see them exploiting their position further in the future.

In the longer term the growing international character of competition is the most significant development for larger building societies. The UK represents for many European and international organisations the most attractive national market in which to develop an initial position because of the sophistication of its financial services sector and its relative openness. The major UK banks are better placed than societies to face this greater competition.

Without freedom from the 1986 Act there is a danger that societies specifically set up to enable people to obtain a home will not in the long run be able to compete in their traditional business.

### **4. Freedom in Future Developments**

It is the Abbey National's view that its objectives, set as a response to the demands of customers as well as the competitive environment, will be best served by the flexibility that will stem from conversion.

#### *Freedom to Determine the Direction –*

Societies must significantly broaden their base in order to develop a position which is both sustainable by being sound and defensible and exploitable by opening up further opportunities, e.g., for cross-selling and improving customer contact. Research carried out by Abbey National indicates clearly that its

membership would like it to provide a wider range of financial services. Before this can be effectively done the Abbey National, for reasons mentioned above, has to free itself from many of the essentially arbitrary constraints which the Building Societies Act imposes.

– *And the Pace*

The retention of mutual status not only precludes societies from developing certain categories of activities or customers, but also places limitations on the pace at which they will be able to develop. A plc, for example, has more options in the ways it can raise capital and therefore greater flexibility in the funding of existing and new businesses. In particular:

- (a) Building societies are restricted to 40% of funding from wholesale sources; whereas banks have in recent years drawn on non-retail sources well in excess of 40% of total funding.
- (b) Constraints exist on the types of financial instruments a building society may employ to generate funds. Unlike banks, societies have to obtain permission from their regulatory body each time they wish to use a new financial instrument. Building societies are thus placed at a disadvantage to competitors in their ability to make use of innovations in the capital markets.
- (c) Building societies are not allowed to issue equity. As a plc, Abbey National would have the option to raise money through equity issues or preference shares to support existing operations or to fund diversification. At present the opportunity to acquire companies for shares, rather than cash, does not exist.

The above factors restrict the pace at which development can take place on a continuous basis. In addition, conversion itself presents a one-off opportunity to generate funds to support and develop the business.

The above account of restrictions to which a building society is subject is not exhaustive; but the point is that any statutory restrictions place a society at a potential competitive disadvantage. Abbey National's future development should be based on the requirements of customers and the demands of the competitive environment and should not be constrained unnecessarily by the restrictions of the Building Societies Act.