Paper on the costs and benefits of building society

Health & Medicine, Beauty

At the beginning of this century there were more than 2000 building societies, fiercely independent mutual organisations, formed in the spirit of Victorian self help. There are now just 71. Some of these that have disappeared were terminating societies with a fixed wind up date. The last " terminating" society was the Fist Salisbury which wound up in 1980. Other societies have been swallowed up in take-overs or converted into banks in the great 1997 demutualisation.

This assignment will discuss this trend with particular reference to the potential costs and benefits in the short and long term. This assignment will examine the costs and benefits to the building societies as well as those to the members and staff.

The Costs and Benefits to the Building Society

Conversion to plc status is seen as having the major advantage that there would be freedom from the limitations imposed by the Building Societies Act 1986, 1997 the statutory framework for the Building Society industry. The restrictions the Act impose include the following:

1) 75% of all lending has to be secured against residential property

This means that Building Societies are limited in their participation in the more risky, but more rewarding unsecured lending. At the moment, Societies can make unsecured personal loans up to a limit of £15, 000 per customer, whereas there is no ceiling for Banks. Building Societies with less than £100m of assets are not permitted to make unsecured loans.

2) No more than 50% of funds may be raised on the wholesale markets

This limit was previously 40% before the revised 1997 Building Societies Act.

Building societies have eagerly taken the opportunity to raisemoneyin the wholesale markets, which have frequently proved to be the cheapest source of wholesale funds (Wholesale funds are large deposits placed by companies and financial institutions, bearing an interest rate in line with the market rate rather than base rates). They have used these funds to even out any shortfall in the inflow of retail funds to meet the mortgage demand.

Banks have no ceiling on raising wholesale funds, which are usually cheaper than retail funds. Building Societies may also find themselves at a disadvantage in access to wholesale funds at competitive rates. As only 50% of funds can be raised from the wholesale market only the very largest societies can maintain the necessary standing in the international capital markets which allows wholesale funds to be tapped on the finest terms. Equally, the capacity to cope with the volatility of the wholesale markets and the risks they pose, requires Treasury management teams on an increasing sophistication to which only the largest societies can aspire.

3) Before the 1997 Act, building societies could only offer temporary or occasional overdrafts to

corporate customers. Now building societies can establish subsidiaries to lend to business customers,

but have not yet become significant lenders to industry. This is in contrast to banks who are very much regarded as lenders to businesses. As a result of the Building Societies Act 1997, building societies are now also able to :

a) make unsecured loans to incorporated businesses;

b) to own a general insurance company which could write housing related policies (buildings, contents and mortgage payment protection insurance).

Building Societies are limited in raising capital. Until 1991 building societies could only raise capital by means of retained profits. Now larger societies, to increase capital, can issue Permanent Interest Bearing Shares (PIBS). This is in contrast to plc" s who are free to raise capital in the market by issuing shares and bonds if they plan to expand. An example of this is Barclays 1987 rights issue to raise £921m tofinance" growth".

Building societies cannot in general engage in take-overs of, or mergers with other types of financial institutions in order to expand their breadth of operations, and retain their mutual status. Banks have this freedom and can finance mergers and acquisitions through the issue of new shares, whereas building societies can only finance acquisitions with cash.

Efficiency is also an issue as a plc - profit making organisation is perceived as having greater efficiency than a mutual organisation. However 'competition has proved a spur to efficiency at least as effective as the disciplinary effect of a public quotation" (PRIMA). As a result of the break up of the societies cartel arrangements for setting interest rates, the banks have made successful inroads into the mortgage and savings markets and hence competition is today very strong.

There are many costs and disadvantages associated with building societies converting to banks including:

The new plc will be regulated by the Bank of England, rather than the building societies commission. The plc will operate under the Banking Act 1987, compared to the Building Societies Act 1987, 1997. The plc may find it difficult and time consuming, at least initially, to deal with the new method of regulation. The Government" s planned new super regulatory body may also provided further legislation that has to be adhered to.

2) Need to pay out dividends and ability and pay competitive interest

The plc will find itself under pressure to pay out growing dividends to shareholders. This reduces retained earnings, thereby reducing the plc" s ability to pay competitive interest rates. In the past building societies have been able to operate on a narrower margin than banks between their rates to the depositors and borrowers because:

a) their low management cost (due to their less complicated specialist business);

b) no requirements to pay dividends;

c) low capital requirements due to the low risk nature of their assets;

d) because the banks tended to subsidise their money transmission service by their deposit accounts, which lessens their ability to compete in the savings market.

3) The plc becomes open to possible take-over bids

The change of status may have adverse effects on the institution" s image with customers. This may adversely affect its ability to compete with Building Societies.

Building Societies are generally regarded as friendly institutions, concerned first and foremost with the customer. A comprehensive study of public perceptions of different financial institutions conducted in 1987 showed that building societies enjoy a positive rating of 85%, compared with only 51% for the high street banks (Personal Finance & The Future of the Financial High Street, Research Associates, March 1988). Building societies have traditionally been seen as a safe depository for the savings of working people. Building Societies are safe and a principal reason why is that mutuality has restricted them to safe, low risk activities. This safety and friendliness have strong customer appeals, which may be lost if conversion to plc status takes place.

In general building societies have low levels of bad debt relative to banks. The lower levels of bad debt can be put down to the loaning restrictions set down by the Building Societies Act 1986, 1997 (e. g. 75% of loans must be secured against residential property).

In 1997 a number of building societies decided to give up their mutual status in favour of plc status. These conversions and take-overs resulted in a number of windfall payments to society members. These windfalls were in the form of cash or free shares. The size of windfall varies from society to society, but investors due to receive windfalls from all the building societies that surrendered their mutual status during 1997 (Halifax, Northern Rock, Alliance & Leicester, Woolwich, Bristol & West) can expect shares worth an average total of about £6, 000 (IC vol. 120/1524 page 34).

This is clearly a short term benefit to members but it is argued that as plc" s these former mutuals will in the long term not be able to offer such attractive interest rates for borrowers and savers. Christopher Rodrigues, Chief Executive of the Bradford & Bingley argues " The one off benefit of plc conversion is here today, gone tomorrow. The higher savings rates and lower loan rates of mutuality are for life not just for flotation day". Mr Rodrigues points out mutuals don" t have to consider the demands of shareholders - particularly for high dividends or share price growth so profits can go to members - via better interest rates on savings accounts for example.

Which?, the respected 'Consumers" Association magazine has also criticised these conversions and claims the new banks will be forced to squeeze customers for maximum profitability. Which? Argues that mutuals offer better interest rates for savers and borrowers.

This case of mutuals offering better rates is hard to prove in practice as there are so many financial intermediaries, products, min balances and interest rates available. For example, the Which? Report only examined two products over a narrow period of time. Most of their mortgage research is based only on the 12 months to March 1997, a period when the converting societies knew they could get away with charging windfall seeking customers more than their rivals.

Over the longer term Money Facts, a savings rate specialist, claims mutuals record in savings rate best buy tables is poor. Each year Money Facts publishes details of how much money you would have if you had invested with each of the 90 or so Tessa providers 5 years previously. Just one of the five largest mutual building societies made it into the top 25 Tessa providers. The same was true last year. A quick look at the mortgage market tells a similar story.

Research conducted by myself paints a similar picture. Investors Chronicle, a weekly investment magazine published by the Financial Times, carries a weekly updated table of highest deposit rates (Appendix 1). As at 29 January 1998 out of 36 financial intermediaries listed on this table offering the best deals on various products (e. g. Tessa, Instant Access up to £2500) only 13 of them are mutual.

In recent months, there has been a rush of new entrants to the banking arena that offer better deals than the mutuals and established high street banks. Insurer, Legal & General (60 Day Notice Minimum £2500 7. 65%) and supermarket, Safeway (Instant Access Minimum £1000 7. 3%) (Appendix 1), for example, both offer excellent interest rates on savings accounts. Equally, Scottish Widows" mortgage products are very cheap.

Even if believed that mutuals offer better savings and mortgage rates it is a long wait for building societies to deliver the same return as there converting counterparts. One case that illustrates this point is a saver that had £5, 000 in an instant access account run by Nationwide - whose members rejected conversion this summer - would earn more money than he would at the

Woolwich (see Appendix 2). However even if you were a non taxpayer, it would take more than 50 years to make £1500 (Woolwich windfall approx. £2000) extra in interest payments. The lure of the mutual building societies is not so compelling as it is often presented.

Some building societies have recognised that they need some sort of scheme with which they can compete with the attractions of windfall bonuses. The Nationwide, Bradford & Bingley and Yorkshire have all announced cash back schemes where members will get a larger slice of the profits in the form of better interest rates. The Britannia has actually paid cash bonuses worth £35m to members. However the average payout to members was £35.

Another aspect of consideration is the treatment the customer receives. Mutuals almost always beat banks in surveys on customer friendliness. Building societies staff are perceived by customers, according to market research, as more friendly, more pleasant and more interested in their jobs than those of banks and other financial institutions. (PRIMA).

Many building societies have branches in estate agents in small communities. These branches are not usually prolifically profitable, but provide a valid service to the community. As plc" s are profit making organisations there is a trend that community branches are closed after conversion. The Abbey National, for example, closed 1000 community branches after conversion and all 200 of National & Provincial" s when it took it over. This is a great cost to those who live in these communities. Many are old people who are now faced with travelling long distances to get their money.

Plc pay is generally higher than mutual pay for the senior managers of a building society. Peter Birch, Abbey National" s, Chief Executive, pay has increased from £173, 000 pa in 1987 to £450, 000 pa in 1996 and he now owns shares worth £1. 8m. This is in contrast to the Chief Executive of Halifax who" s pay did not increase by anywhere as much and was unable to receive share options. There is a clear benefit to the senior mangers of a converted building society, but in the long run they are also more open to being removed by discontented shareholders or a take-over. Share options are believed to produce more motivated and committed staff.

In conclusion there are potentially more benefits to the Building Society than costs. The major benefit being the escaping from the limitations imposed by the BSA. The Building Societies Act 1986, 1997 excluded building societies from potentially more profitable, if riskier business. The regulatory constraints on a plc are less onerous than those on a mutual basis therefore although banks are subject to continuous Bank of England supervision, the basic limitations are the scope of company articles of association whereas building societies must comply with highly specific requirements of the Building Societies Act 1986, 1997 on such matters as the permitted proportions of wholesale funding, unsecured lending and advances by class of asset.

In general, members also have potentially more benefits than costs. In the short-term members of converting societies have the benefit of windfall payments. In the long run it is claimed that members will lose out in less competitive interest rates, however this is very hard to prove. Even if it can be proved, the savings and mortgage rates offered by the mutuals will only be marginally better than those offered by the non-mutuals. It will take years to earn the equivalent of a windfall bonus from a mutual in the form of better interest. Some people urge others to think about the next generation and that one day there will be no mutuals left, but at present most of the best rates are offered by the new entrants to the banking arena (e. g. Safeway).

Any member who retained their membership of a converted society through retaining their share allocation, at present would be benefiting even more. The reason for this is that the share prices are higher today than when the societies floated. Secondly as this is being written the Woolwich as part of it" s maiden full year results announced a " fresh £100m windfall for Woolwich investors. A 6. 5p special dividend added to the total year dividend of 9. 5p will put £105 in the pockets of hundreds of thousands of former Woolwich members who received the average windfall package of 657 shares. The Woolwich will also seek authority to return a further 100m to 200m of excess capital to share holders later this year in share buy backs.

There is a clear cost to those members who relied on a community branch, however have these usually retired people examined the alternativetechnologyavailable (e. g. telephone banking, cheques, debit cards etc.).

Staff (particularly senior management) will benefit as a plc is able to offer share options which are believed to produce more motivated and committed staff. Senior management will also usually have greater increases in pay. These people are not 'FAT CATS" they do a complex job and are paid the going market rate. In the long run senior managers of a plc are easier to remove from the company if their performance is poor.

All in all the benefits of conversion outweigh the costs. This is true for all the interested parties, i. e. the building society, the members and the staff.