A CIVIC APPROACH TO FINANCIAL REFORM IN THE UK

David T Llewellyn

1. INTRODUCTION AND OVERVIEW

A central theme of the Civic Approach to financial reform is that consumer interest through enhanced effective competition and systemic stability are enhanced through diversity in the financial system. This applies most especially with regard to contrasting business models and in particular the balance between Shareholder Value firms and mutuals.

A generic distinction is made between Shareholder Value (SHV) banks and financial firms and Stakeholder Value (STV) banks. The STV sector in the British financial system includes mutual building societies and insurance companies, cooperatives, Friendly Societies, Credit Unions, and Industrial and Provident societies. In continental Europe the dominant STV institutions are Cooperative banks which have a far greater and more extensive role in the financial system than do mutuals in the UK. The essential characteristic is that, unlike SHV banks, their primary purpose is not to maximise profits but to focus more explicitly on the interests of customers who are also their owners. This is a fundamentally different culture from that in SHV banks: mutuals are under no pressure to maximise profits so as to increase returns for external shareholders many of whom (institutional shareholders) are themselves under pressure to maximise returns (often on the basis of short time horizons) for their own investors and stakeholders. The two types of banks compete along side each other in several key markets notably savings, mortgages, and consumer loans.

There is, therefore, an element of diversity in the financial system. In practice, however, (and in contrast to many other European countries) the degree of diversity is low and has been in decline for several years. A major factor in this decline has been the conversion of ten of the largest mutual building societies (accounting for 70 percent of the combined assets of building societies at the time) to plc (SHV) bank status in the 1990s, along with some large insurance companies.. This substantially eroded the critical mass of the mutual sector in banking and insurance and life assurance markets. As a result, the financial system has come to be dominated by the SHV model which has created something of a mono-culture.

When comparing the two basic models, three key dimensions need to be considered: (1) the intrinsic merits and drawbacks of the different models, (2) the incentives for financial firms with different business models to take risk, and (3) the advantages to be gained through diversity, most especially with respect to enhancing effective competition and systemic stability.

Two central themes of the Civic Approach are that the mutual model in finance remains a valuable and viable alternative to the dominance of the SHV model, and there is a consumer and public policy interest in enhancing diversity. On the basis of both theoretical analysis and recent experience, there can be no presumption that the typical SHV model is best for all types of financial transactions. On the contrary, and as many analysts have demonstrated, many financial transactions (most especially those that are low risk, and where there is an on-going customer relationship with the provider of financial services) are more suited to the mutual model. The position has been put well by John Kay:

> "the special value of mutuality rests in its capacity to establish and sustain relational contract structures. These are exemplified in the most successful mutual organisations which have built a culture and an ethos among their employees and their customers, which even the best of plc structures find difficult to emulate" (Kay, 1991).

There are strengths and weaknesses in all business models. However, and irrespective of these, there is a systemic advantage in having a mixed system and a strong critical mass of institutions (most especially mutuals) that are not dominated by the SHV model.

This seems to be accepted by the Coalition Government in the UK as, in the wake of the financial crisis, the Government's proposals to reinvigorate competition in the banking sector included:

> 'supporting competition and choice through diversity, most importantly through maintaining a strong mutually-owned financial sector'.

This reflects a consensus across the major political parties for diversity of corporate form within financial services, with a strong mutual sector. The cross-party support for the Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 had already demonstrated this broad political consensus. The case has become even more compelling given the performance of the private banking sector since 2007.

In this context, there are four compelling reasons for creating an enhanced role for mutual building societies and other financial institutions such as credit unions, friendly societies:

1. The ownership structure, regulation and traditional business model of mutuals (particularly the dominance of retail funding) makes them less prone to risky speculative activity than is the case with shareholder-owned banks.
2. A mixed system of different corporate structures is likely to produce a more stable financial system.
3. A larger critical mass of mutuals is likely to enhance effective competition in the financial system. Competition is likely to be more effective through different business models than by adding more institutions with the same business model. This is a limitation of the Challenger Bank approach as such banks have been SHV-based.
4. It would contribute to eroding the mono-culture and dominant position of SHV banks.

Several recent studies (for instance, two reports – Ayadi, *et.al*, 2009 and 2011 - issued by the Brussels-based Centre for European Policy Studies) demonstrate clear economic, systemic and welfare benefits to be derived from a successful mutual or cooperative sector in the banking system. A financial system populated by diversity of ownership and governance structures, and with contrasting business models, is likely to be more competitive and systemically less risky than one populated by a single dominant model, whatever that model might be. This is what makes the enhancement of diversity a major public policy issue in finance.

2. PROBLEMS IN RETAIL FINANCE

In many ways the financial system is not serving a wide range of retail customers as well as it should or could. Several elements of this market failure can be identified:

- **Lack of diversity** in terms of ownership structure of financial firms, corporate governance arrangements, capital structure and, above all, business models. Three particular observations are to be made in this area: (1) the degree of diversity is considerably lower in the UK (because of the dominant position of the SHV model) than elsewhere in Europe; (2) the evidence indicates that diversity has decreased in the UK while it has tended to increase in other European countries, and (3) the erosion of critical mass of the mutual model in the UK compared with other European countries.

- The lack of diversity is particularly marked with respect to **business models** of financial firms which has the effect of reducing consumer choice and effective competition.

- **Lack of truly effective competition** (both *structural* and *behavioural*) in some retail markets. This is partly because of: structural weaknesses in the competitive environment; a lack of diversity in business models; the difficulty in some markets for consumers to make rational choices between products and firms (e.g. because of complexity and lack of transparency, etc.), and sometimes high transaction costs of switching between different suppliers and products.

- **Complexity of charges, prices and some financial products together with a lack of transparency.** This clearly limits the extent to which competition is truly effective as it is difficult for consumers to make informed comparisons. What is often "excess complexity" also makes it difficult for consumers to fully understand the true costs of some products and their risk characteristics. Over-complexity can reduce consumer welfare both because it may make it difficult for consumers to understand the full characteristics and risks of the product and may, as a result, result in buying inappropriate products. But equally, also because such complexity might deter consumers from buying products that they should be buying.

- **An unnecessarily complex intermediation structure** between the consumer and the ultimate supplier of products which adds to overall costs for the consumer. This amounts to an unnecessarily complex value chain in some financial products.

- **Incentive structures** within the financial system at two levels: inherent in the SHV model (maximising shareholder value), and within financial firms: bonuses based on sales, etc.

- **Consumer Trust and Confidence** in finance is currently low though, because of the nature of financial products and transactions, and the potential vulnerability of retail customers, trust and confidence is crucial in retail financial markets. Consumers may be distrustful of some aspects of the culture of financial firms.

- **Lack of access** (financial exclusion) to financial firms and products for some (low income and vulnerable) consumers.

- **The market for genuinely independent advice** for consumers is weak in the case of some financial transactions at a time when it is essential for such advice to be available. There is clear evidence of the extent to which, partly as a result of recent regulatory changes, several retail banks have exited from the independent advice market.

A key issue to consider is the extent to which enhancing the role of the mutual sector, and fostering greater diversity of models in the financial system, can contribute to alleviating these market failures.

3. A *CIVIC APPROACH* TO FINANCIAL REFORM

In this general context, this report advocates what might be termed a *Civic Approach* to financial reform. What has probably been one of the biggest-ever banking crises, has predictably been followed by one of the biggest-ever set of changes in the regulatory regime designed to make banks more safe and reduce the probability of crises in the future. This has focussed mainly on the prudential position of banking institutions (what might be termed the *Prudential Approach*) with emphasis on capital, liquidity and, to a limited extent, institutional structure of banking institutions (ring-fencing, etc). In essence, the approach has been institutional.

Regulatory reform under the *Prudential Approach* has been constructed on the basis of accepting the current institutional structure of the financial system as a given. In the *Civic Approach*, on the other hand, the focus is on the consumer of banking and retail financial services, and reform to the institutional structure of the financial system as a whole rather than individual institutions. In particular, it addresses five key issues:

(1) Increased diversity in the financial system most especially with regard to greater plurality of business models and the balance between the currently dominant SHV model and the alternative mutual model.

(2) Enhanced effective competition: both *structural* (concentration, entry barriers, etc) and *behavioural* (ability of consumers to make rationale choices and to execute them at low cost).

(3) Aspects of the financial services sector (such as unnecessary complexity, lack of transparency, weaknesses in the provision of advice, weak consumer Trust and Confidence, etc) which are hazardous for consumers.

(4) Given powerful demographic factors, coupled with severe government budget constraints, there is a long-run imperative for the personal sector to save more and to shift some of the burden of pensions provision away from the tax-payer.

(5) For the same reasons, current levels of welfare and pensions provision are unsustainable. Consideration needs to be given to alternative sources of provision (including people themselves through higher saving). There is a potential role for mutuals alleviating the strain on the DWP in the area of welfare.

The two alternative approaches (*Prudential* v. *Civic*) are not mutually exclusive as the *Civic Approach* does not deny the need for enhanced prudential regulation and supervision of banking (and other) institutions.

Equally, a central feature of the *Civic Approach* is that increased diversity enhances both systemic stability objectives and direct consumer benefits through its potential impact on consumer choice and effective competition. The *Civic Approach* is, therefore, more holistic by addressing a wider set of issues. Above all, the focus and starting point of the *Civic Approach* is the consumer of financial services.

4. SHV v. STV MODELS IN FINANCE

Most European countries have a mixed system of SHV and STV banks. There is empirical evidence (PA, 2003) that the size of the STV sector in a country has an influence on the profitability of SHV banks in that the higher is the proportion of banking business that is conducted by STV banks, the lower tends to be the profitability of SHV banks. Mercer Oliver Wyman also find that, in a comparison of mortgage pricing across Europe, low prices have largely been associated with strong mutual shares of the market. A significant presence of STV banks in a financial system tends to constrain the pricing power of SHV banks.

European banking is a heterogeneous industry with respect to issues such as ownership structures, governance arrangements, capital structure and business objectives. We conceptualise SHV banks as those whose primary (and almost exclusive) business focus is maximising shareholder value and the rate of return on equity.

In contrast, in the STV model there are many stakeholders and most especially its members. In the STV approach, while profitability is needed to finance future growth, it is not the exclusive, or even primary, objective. In practice, this means that an STV bank will not pursue profit maximisation to the same degree, or with the same intensity, as will SHV banks, (Llewellyn, 2005). The position is described well in Christen *et.al*. (2004) and in Ayadi *et.al*. (2009) as "Double Bottom Line" institutions indicating that STV banks need to generate profit in order to survive and expand, but that profit is not the sole or even primary bottom-line objective.

Mutuals have been defined by the European Commission as

> "voluntary groups of persons whose purpose is primarily to meet the needs of their members rather than achieve a return on investment. These kinds of enterprise operate according to the principles of solidarity between members, and their participation in the governance of the business." (European Commission, 2003)

A key difference between mutuals and SHV banks is that in the former the customers are themselves the "owners" (members) whereas there is a separation of the two in the case of SHV institutions. The objective of a mutual is to look after the interests of its members who, in the main, are also its customers and owners.

British building societies were originally established as mutual self-help organisations as long ago as the 19th century. For a long time, mutual institutions dominated housing finance and life assurance markets both in the UK and in many other European countries. This was particularly true in the UK housing market where, for several decades, mutual building societies dominated the market, even after the intensification of competition which followed deregulation and the entry of banks and wholesale-funded lending institutions in the early 1980s. Not only have mutual institutions tended to dominate certain segments of the financial services market, they have also enjoyed a superior public image compared with their SHV counterparts and have compared favourably in terms of performance measures such as cost/income ratios.

The mutual and Cooperative corporate forms have been prevalent, and have a long history, in financial services. Mabbett (2001) notes that “for much of the twentieth century, insurance against risks faced by householders was understood to be an inherently mutual activity”. In many ways, mutuality may be particularly suited to the provision of some financial services, and especially those relating to longer-term contractual relationships such as mortgages and life assurance. This may be due in part to the possibility that financial mutuals are able to address agency problems more efficiently. As a result, they also have a comparative advantage in establishing trust (Kay, 2006) which is important in three cases in particular: consumer “lock in” (transaction costs or penalties of exits are high); where there is asymmetric information between the firm and the customer, and in the case of longer-term contracts.

There are good reasons why different corporate forms coexist within the same marketplace, and there is a clear economic rationale for the predominance of mutuals in cases where institutions are focused on providing long-term financial products (such as mortgages and life assurance) where long-term customer relationships are involved. Similarly, the literature on property rights and ownership structure can help to explain why relatively risky and highly diversified activities such as commercial banking tend to be dominated by SHV forms. This clearly helps to explain the historic relative dominance of mutuals in areas such as mortgage finance and life assurance which involve long term relationships with customers.

5. STVs IN THE UK AND EUROPE

Co-operative banks, credit unions and other financial mutuals play a substantial role in most European economies and, in contrast to the experience of mutual building societies in the UK, have increased their share of banking business over the past ten years. The UK is out of step, having travelled in the opposite direction since the demutualisations of the 1990s. Five EU member states (including France and Germany) have more than a 40 percent share of co-operative or mutual banks in terms of branch networks. An IMF study (Hesse and Čihák, 2007) finds that the overall market share of co-operative and mutual banks in terms of total banking sector assets increased from about 9 per cent in the mid-1990s to about 14 per cent in 2004. Their overall conclusion is that Cooperative banks are more stable than commercial banks, and have advantages for consumers.

In the UK there are currently 47 building societies with [23] million investors. Mortgage assets amount to [£258] billion and total assets [£330] billion. Building societies remain, therefore, a significant part of the British financial system. Mutual lenders and deposit-takers have total assets in excess of [£375] billion and mortgages of [£245] billion (20 percent of all outstanding household mortgage loans). They have [£250] billion in retail deposits (22 percent of the total) and around 2,000 branches.

The size of the mutual sector and the number of mutual building societies has declined substantially. At one time, building societies accounted for 60 percent of the mortgage market which has declined to around 20 percent currently. In 1910 there were 1,723 many of which had their historical origins deep in the nineteenth century. For a concise history of the building society sector, see (Drake, 1999). By 1992 the number had been reduced by mergers to 89 and further to 55 by the end of 2008 through a process of mergers and by several conversions to SHV bank status. The 1986 Building Societies Act conferred more business powers on building societies (though still with prescribed limits) but at the same time enabled members to vote for conversion to SHV bank status. A total of ten building societies (including eight of the largest ten that existed in 1992) subsequently converted (or in some other way abandoned their mutual status) and these accounted for 70 percent of the total assets of building societies in 1992. However, not one of the building societies that converted to bank status has survived as an independent bank.

Partly as a result of these trends, since the 1980s the financial sector has become less diverse with the ascendancy of the SHV model.

The experience of continental European countries in the balance between SHV and mutual (cooperative) banks is instructive. Although there are similarities between mutual building societies in the UK and Cooperative banks elsewhere in Europe (most especially with regard to corporate objectives and the principle of one-member-one-vote), the differences are substantial:

- Partly as a result of de-mutualisations in the 1990s, Building Societies generally have a lower market share of retail deposits, mortgages and consumer loans than do many Cooperative banks in continental Europe.
- The capital of a building society belongs to the members rather than, as with Cooperative banks elsewhere in Europe, being held in perpetuity by the bank itself. The capital base of a Cooperative bank (i.e. its net asset value) does not belong to the current cohort of members. Capital is essentially an inter-generational endowment held by the cooperative in perpetuity for the benefit of current <u>and future</u> members. Capital cannot, therefore, be appropriated by the current cohort of members as future generations are counted amongst the stakeholders. The concept of de-mutualisation is alien (if not legally possible) in most European countries. In this country (unless restrictions have been agreed) members are able to vote for conversion to SHV status and receive a share of the capital. In other words, the current cohort of members is able to vote for an inter-generational transfer from past and future members to themselves.
- The business of building societies (including funding strategies and the balance between wholesale and retail funding) is considerably more restricted by law than is the case with Cooperative banks in Europe. Unlike in many other European countries, they cannot compete with SHV banks across the full range of business.
- There is no Central Network Institution in the building society sector although attempts have been made for some societies to combine together for the provision of some back-office services (see later section).

In 2009 and 2011, the Centre for European Policy Studies published two major studies of European Savings and Cooperative banks. The analysis – both theoretical and empirical – found that such STV banks enhance competition in the financial sector, enhance stability characteristics, contribute to alleviating social exclusion and, because of their local focus, contribute to regional development. In particular, a strong case is made in favour of diversity in the financial system with contrasting business models competing with each other. Some aspects of the European experience from the CEPS studies may be summarised:

- There is greater diversity in the financial systems in continental Europe than is the case of mutuals in the UK. STV banks are more prominent than in the UK. STV banks are an integral part of financial systems in continental Europe, and there is no presumption in continental Europe that the SHV model is the norm.
- There are substantial variations within each model: the European Cooperative banking sector was described as *Commonality with Diversity* (Ayadi, *et. al.*, 2011)
- There is little, if any, difference between SHV and STV banks in terms of efficiency, etc.
- A common feature of Cooperative banks in Europe is that they have Central Network Institutions (CNIs) which means that small banks can gain the advantages of economies of scale by outsourcing to a commonly-owned organisation. It remains an enigma why the UK building society sector is almost unique amongst STV banks in Europe in not having CNIs. Prime examples in Europe include Rabobank (Netherlands), BCPE (France), OP-Pohjola (Finland), Credit Agricole and Credit Mutuel (France). These CNIs centralise the provision of a range of services and production processes for their member institutions. The centralised services include, for instance, back-office and representation services, product development, and liquidity and risk management services.

- In most countries in the EU (but not in the UK) some form of mutual support exists among the cooperative banks: cross-guarantees, etc.
- The market share of STV banks has tended to rise in continental Europe whereas it has declined (mainly because of de-mutualisations) in the UK.
- Cooperative (mutual) banks tend to have lower volatility of earnings than do SHV banks. This is partly because STV banks have a lower risk profile than do SHV banks.
- STV banks in general (though with exceptions) were less affected by the banking crisis than were SHV banks. It is significant that the banks in the UK that got into most difficulty were de-mutualised building societies.

In the insurance sector, the de-mutualisation in the late 1990s and early 2000s (Norwich union, Friends Provident, Standard Life, Scottish Widows, Scottish Provident) and the close of Equitable Life, substantially eroded the role of mutuals in the insurance and life assurance sectors. As a result, the mutual sector has come to be considerably smaller in the UK than almost everywhere else in Europe. In continental Europe, over 40 percent of all insurers are mutual and their market share is around 25 percent (non-life 40 percent and life assurance around 17 percent). Table 1 gives the market share (percent) for selected countries.

Table 1

	Life	Non-Life	Total
Austria	59	63	61
Denmark	56	21	45
France	16	60	32
Germany	37	44	40
Netherlands	29	56	47
Sweden	34	55	41
UK	**5**	**12**	**6**

With regard to Credit Unions, they are more common in many other countries (notably the US, Canada, Australia) than is the case in the UK. However, they are growing in this country albeit from a low base. In June, 2012 ABCUL was contracted by the DWP to deliver what is termed the Credit Union Expansion Project designed to modernise and grow the sector, and the DWP allocated £38 million to the project. The plan is to enhance the role of Credit Unions and to create a competitive and attractive range of products. ABCUL also provides some centralised services to Credit unions through Cornerstone Mutual Services (CMS). It is envisaged that CMS will develop a shared business model incorporating a shared provision of some components of the credit union business model such as branding, marketing, range of products, some operations and IT functions.

The main aims of the project are to: expand the role of Credit Unions, introduce new products, enhance the role of CMS, develop an automated credit-scoring facility, and increase the number and extend the range of members of Credit Unions.

6. KEY CHARACTERISTICS AND BENEFITS OF THE MUTUAL MODEL: *Commonality with Diversity*

Whilst there are common characteristics in mutual financial institutions, building societies are not totally homogeneous as variations appear in terms of their size, the extent to which they are focussed in a particular locality, and the range of services offered. For instance, while a few Societies offer current accounts, this is not universally the case.

Several key characteristics encapsulate the essence of the mutual model in whatever sector of the financial system they are:

- In contrast to SHV banks, maximising the rate of return on capital is not the exclusive or even dominant business objective of mutual building societies. The essence of the mutual model is that there is no myopic focus on maximising shareholder value. The typical mutual seeks to maximise the benefit of their members and to maximise consumer surplus. The interests of members rather than external shareholders are at the centre of mutuals' business strategies.

- Mutuals usually have an element of a "social mission" often, though not exclusively, focussed on the local community.
- While the cost of capital of an SHV bank is a claim on revenue (through, for instance, the payment of dividends to outside shareholders), mutuals are not required to service externally held capital. This gives them a potential "margin advantage" which can be used in terms of the pricing of deposits and loans for the benefit of members. The absence of external shareholders in mutuals is an inherent advantage in that, other things being equal, they should be able to operate on lower margins. This margin advantage can be incorporated in lower lending rates and/or higher deposit rates. On average, interest rates on savings at building societies have been 45 bp higher than in banks though, with the historic low level of interest rates in the UK, this margin has narrowed in recent years. In the mortgage market, mutuals' interest rates have on average been 38 bp lower than with banks though again this has narrowed recently. Overall, the net interest margin is lower with building societies than with banks.
- Voting rights conferred by membership are based on the principle of One-Member-One-Vote and are not proportional to the size of a member's stake in the society. The implication is that the ownership rights inherent in OMOV model are necessarily widely dispersed with no individual or group able to build up a controlling position.
- Mutuals are owned by their members, and although a building society may have customers who are not members, a key feature of building societies is that, in general, there is no separation of owners and customers. They therefore tend to be more customers focussed.
- Most building societies are locally based and have a particular focus and expertise on the local community. This has the effect of mitigating the powerful centrifugal tendencies in the financial system.

- Unlike with SHV banks, ownership stakes are not marketable and members cannot sell their ownership stakes in a secondary market. Because of this, there is no market in corporate control in that it is virtually impossible for hostile bids for ownership to take place: a mutual building society cannot be bought by new owners through a hostile bid.
- The almost exclusive source of capital for a building society is its retained profits. There are no external shareholders/owners who are not themselves members of the building society. There are no specialist outside risk-takers supplying equity capital which needs to be separately remunerated.
- In general, all profits are retained within the society and added to reserves (capital) and dividends are generally not paid.
- Mutuals, in general, and building societies in particular tend to adopt a lower risk profile than the typical SHV bank partly because of their ownership structure. The May 2009 Report of the Treasury Select Committee concluded that:

> "To date, building societies have generally been shown to have operated a safer business model. Certain features of the building society model, including the low reliance on wholesale funding and the focus on the protection of members rather than the service of shareholders, have left building societies better equipped to defend against the shockwaves of the current crisis"

The evidence suggests that, across Europe, STV banks tend to be more stable than commercial banks with lower volatility of returns (Groeneveld and de Vries, 2009, and Ayadi, *et. al*., 2011). Furthermore, such banks came out well in the recent crisis compared with banks.

Mutuals tend to be specialised and relatively low-risk institutions, and tend to engage in less risky activity (see, for instance, Cihak and Hesse, 2007). Mutual financial institutions have traditionally been narrowly focused and relatively low-risk institutions as a direct consequence of restrictive regulation. However, mutuals would tend to adopt a lower risk profile even in the absence of such regulation. Firstly, they are not under pressure to maximise profits which, at times, induces SHV banks into a higher risk profile. Secondly, mutuals are under less short-termist pressure and are more inclined to adopt a longer-term horizon in their business decisions. Thirdly, as it is less easy for mutuals to raise external capital they tend to have a lower risk appetite than SHV banks as capital that is destroyed cannot easily be replaced. Finally, the fact that building societies and other mutuals are owned by their members (rather than large institutional investors) makes them less prone to the asset-substitution problem and hence less inclined towards risk-taking (Drake and Llewellyn, 2001).

A key issue focusses on the incentives to take risk. SHV Banks often face incentives to take on excessive risk as shareholders face capped losses but no cap on potential gains. In evidence to the Parliamentary Commission on Banking Standards, some banks suggested that bank management faced pressure from shareholders to increase leverage (and hence risk). RBS suggested that "in some instances investors pressed for what were arguably unsustainable levels of return, creating pressure to increase leverage and take on additional risk". Compared to this, building societies being owned by their members/customers, face no immediate conflict of interest between customer and owner: as owners, members have the nominal status of equity holders but on the basis of a debt contract (deposits). Mutual members have no upside gain through risk-taking and, in general, are themselves risk averse. As a result of their ownership structure, the culture of mutuals is quite different from that in SHV banks. The position has been stated well by Andy Haldane of the Bank of England:

> "Mutuality may do a lot better job of aligning stakeholder incentives than some alternative forms of corporate governance" (Haldane, 2009)

The lower risk of building societies is also seen, for instance, in their lower level of mortgage arreas which, on average, are around two-thirds of the level across the market as a whole. Furthermore, building societies fund themselves predominantly in the retail deposit market rather than the more volatile wholesale markets. The legislation governing building societies restricts the extent of wholesale funding to a maximum of 50 percent and in practice such funding represents only around XX percent of their total funding.

7. LACK OF DIVERSITY

Our central theme is that there is a public policy interest in fostering diversity in the financial system. And yet, diversity has declined steadily over the years. Furthermore, the degree of diversity is less in the UK than in many other European countries where there has been little, if any, decline. The UK government committed in the 2010 Coalition Programme to bring forward proposals "to foster diversity in financial services, promote mutuals and create a more competitive banking industry."

A general case for diversity has been made well by Michie (2010):

> "..(diversity) creates a corresponding diversity in forms of corporate governance, risk appetite and management, incentive structures, policies and practices, and behaviours and outcomes. It also offers wider choice for consumers through enhanced competition that derives in part from the juxtaposition of different business models"

There are several aspects of a lack of diversity in the financial system: the dominance of large SHV banks, the balance between SHV banks and mutuals, the power of Too-Big-To-Fail banks and the implicit subsidy they receive, and the decline in the degree of diversity within the SHV bank sector. The conversion of some of the largest building societies in the 1990s produced a major structural change in the British financial system and severely weakened the balance between mutuals and SHV institutions in the retail savings and mortgage markets, and also in the insurance market. The conversion movement was, in part, a reflection of the free-market consensus that came to favour the SHV model in banking.

A de-mutualisation could only occur on the votes of existing members. Unlike in continental Europe, de-mutualisation of building societies (and mutual life assurance offices) involved payments to current members as the concept of inter-generational legacy was not enshrined in British law. Although the reserves of building societies are built up over several generations of members, on a de-mutualisation the current cohort of members have claim on the economic value of the mutual. In effect, members are "compensated" for surrendering the benefits of mutuality. In essence, de-mutualisation involves the appropriation of the mutual's intergenerational endowment by the current cohort of members. This also implies that, by definition, potential future members have no say in the process and the current generation of members are able to deny future generations the benefits of membership of the mutual. This represented an inter-generational transfer of benefits and wealth (to current members from the accumulation generated by past members and the benefits of potential future members) and, under these circumstances, it is perhaps not surprising that members have tended to vote in favour of de-mutualisation. The economic rationale for the demand for conversion could be regarded as a demand by existing members of societies to unlock their entitlement to *locked* value. For a more detailed discussion of the reasons for conversion see Drake and Llewellyn 2001). In practice, however, it became opportunistic in that the motive was to secure windfall gains (sometimes amounting to several thousand pounds) for individual members.

By 2008 all the converted societies had lost their independent status either because they were purchased by other banks (e.g. Abbey National and Alliance & Leicester were purchased by Bank Santander), or because they failed and needed to be taken into public ownership (notably Northern Rock). Much has been lost to the British financial system by the demutualisation of building societies, both in terms of the intrinsic merits of the mutual model, and in terms of competition and systemic diversity. A former Non-Executive Director of the Halifax when it was a mutual has argued:

> 'It is now apparent that the conversion of the mutual building societies to public limited companies did, in the end, inflict considerable damage on the UK financial services sector. All the large societies that converted either failed or were absorbed into larger financial conglomerates. This reduced competition, and the institutions that were eliminated had achieved significantly higher levels of customer satisfaction than their listed counterparts". (Kay, 2009).

Andrew Bailey of the Bank of England, speaking at the 2011 Annual Building Societies Conference has argued that:

> "Demutualisation, as it developed, was a failed and very costly experiment"

As argued above, this is generally not possible in other European countries where the law requires the reserves of any de-mutualised bank must be transferred to another Cooperative bank or otherwise used for purposes of general interest. Above all, they cannot be appropriated by the current members. Since the wave of de-mutualisations, most remaining mutual building societies have put in place various mechanisms (such as charitable assignments) to prevent current members having any claim on the economic value of a de-mutualised society.

Tracking the trend of diversity in the financial system has recently been made possible with the construction of a Diversity Index (Michie and Oughton, 2013) incorporating four main components: ownership model of financial firms, the degree of concentration and competitiveness, funding models of financial institutions, and geographical concentration of financial services. The profile of the overall Diversity Index (chart 1) which shows a clear downward trend in diversity since 2004. In terms of diversity of ownership structures (a proxy for SHV and mutual building societies), there has been a similar decline in terms of mortgages though not in terms of deposits, (chart 2).

Chart 1

Chart 2

The decline in funding model diversity produced higher system risk. This is also discussed in Haldane, (2010), Haldane and May, (2011), and Goodhart and Wager, (2012).

The case for financial structure diversity has been made by official agencies and published empirical research. Thus, the EU Commission published a report in 2007 on European retail banking. The European Parliament subsequently issued a Resolution on 5th June, 2008 which argued:

> "the diversity of legal models and business objectives of the financial entities in the retail banking sector (banks, savings banks, co-operatives, etc) is a fundamental asset to the EU's economy which enriches the sector, corresponds to the pluralist structure of the market and helps to increase competition in the internal market"

Two studies by the Centre for European Policy Studies find that

> "legal, political, and risk-related considerations serve to highlight the need for a European banking model based on diversity…."

Smolders, et al (20XX) come to similar conclusions with respect to European Cooperative banks which were found to be more stable than SHV banks. For instance, the share of Cooperative banks in total losses during the crisis was considerably smaller than their overall market share. Although there are always exceptions, the general picture to emerge from a wide range of studies is that STV banks have a more conservative approach to risk and risk management than the generality of SHV banks. The conclusion of several studies is that the presence of STV banks adds to the stability of the financial system.

A report from the International Monetary Fund (Hesse and Cihak, 2007) investigated the impact of Cooperative banks on financial stability in a sample of 29 countries and found that cooperative banks tend to be more stable than SHV banks. In another IMF study (Fonteyne, 2007), Cooperative banks were found to be less fragile than other banks because of their more stable deposit base and their not seeking to maximise profits. In a study of German banks, Beck et al (2009) find that Cooperative banks are the most stable financial institutions in Germany.

Overall, therefore, the empirical and theoretical analysis powerfully suggests clear systemic benefits from the existence of a continuing and thriving mutual sector: a financial system characterised by a mixed array of corporate structures such as plcs and mutuals will be inherently more stable than one populated by either model alone.

Given the inherent 'margin advantage' of Building Societies, and the systemic advantages of a mixed financial structure, there are economic and welfare benefits to be derived from a viable and successful building society sector with a larger critical mass. There is a powerful *systemic* interest in sustaining a strong mutual sector and, therefore, it is a significant public policy issue. There are several key issues in this regard:

- The effect that a strong mutual sector has in enhancing competition because of their different business model.
- Because mutuals are not owned by investment institutions, they are not subject to the short-termist pressure of the capital market.

- The systemic advantage through having a mix of institutions with different portfolio structures. A pluralistic approach to ownership and business models is conducive to greater financial stability. The more diversified is a financial system in terms of size, ownership and structure of businesses, the better it is able to weather the strains produced by the normal business cycle (in particular avoiding the bandwagon effect) and the better it is able to adjust to changes in consumer preferences. As put in a *Financial Times* editorial (27 April 1999):

> '………a pluralist approach to ownership is conducive to greater financial stability. With their contrasting capital structures, banks and building societies balance their risks and loan portfolios differently. Systemic risk is therefore reduced'.

Ayadi *et.al* (2011) argue the case for diversity:

> "reducing institutional risk, defined as the dependence on a single view of banking that may turn out to have serious weaknesses under unexpected conditions such as the current crisis."

- In an uncertain market environment, diversity has advantages as it cannot be predicted which form of corporate structure is best suited to all particular circumstances.

The issue of having a financial system populated by a diversity of organisational forms is as significant as the merits and drawbacks of each particular model. The case for maintaining a significant mutual sector in the financial system is wider than any alleged intrinsic merits of mutuality. It is in this respect that a significant public policy issue arises.

For genuine diversity to deliver its potential benefits two features are needed: there need to be clear differences in corporate objectives and behaviour, and there needs to be sufficient critical mass for the different business models.

While not explicitly discussing mutuals, the Executive Director for Financial Stability at the Bank of England, Andrew Haldane, set out the beneficial effects of diversity for the robustness of financial networks:

> Within the financial sector, diversity appears to have been reduced for two separate, but related, reasons: the pursuit of return; and the management of risk. The pursuit of yield resulted in a return on equity race among all types of financial firm. As they collectively migrated to high-yield activities, business strategies came to be replicated across the financial sector. Imitation became the sincerest form of flattery.
>
> So savings co-operatives transformed themselves into private commercial banks. Commercial banks ventured into investment banking. Investment banks developed in-house hedge funds through large proprietary trading desks. Funds of hedge funds competed with traditional investment funds. And investment funds – pension, money market mutual, insurance – imported the risk the others were shedding…
>
> Through these channels, financial sector balance sheets became homogenised. Finance became a monoculture. In consequence, the financial system became, like plants, animals and oceans before it, less disease-resistant. When environmental factors changed for the worse, the homogeneity of the financial eco-system increased materially its probability of collapse. (Haldane, 2009a, pp. 18-19)

8. *Effective Competition*

One of the elements in the Civic Approach to identifying the weaknesses in the retail sector of the financial system is the lack or limitations of effective competition. This has two elements: *structural* and *behavioural*. The former relates to, for instance, the lack of diversity in business models, the high degree of concentration in banking in general and the SHV sector in particular, entry barriers, etc. In fact, market concentration is greater in the UK than was the case ten years ago. The structural aspects have been considered in great depth by the Independent Commission on Banking and the Parliamentary Committee on Banking Standards and therefore will not be discussed further. As argued in the ICB's Final Report:

> "There have been long-standing problems with competition in UK retail banking markets, resulting in competition being both insufficient and misdirected"

The *behavioural* dimension is equally important though has received less attention. This relates to the characteristics of financial products (complexity and lack of transparency, etc), and the ability of consumers to make rational choices and execute them at low transactions costs.

Overall, the PCBS argues: “The UK banking sector is not as competitive as it should be”. An earlier Report (from the All-Party Group for Building Societies and Financial Mutuals) concluded that:

> “the previous demutualisations have restricted consumer choice, as the mutual sector has acted as a check on the plcs both in terms of value and on ‘non-financial’ issues such as branch closures and charges on ATM machines”.

In effect, demutualisations have weakened diversity and effective competition in the retail financial services sector.

The government has often declared its intention to improve competitiveness in the retail financial sector:

> “supporting competition and choice through diversity, most importantly through maintaining a strong mutually-owned financial sector. (Through for instance) ensuring that its regulatory and legislative framework is modernized; supporting better governance, and considering the sector’s needs for capital and funding” (HM Treasury White paper, *Reforming Financial Markets*, 2009).

A general measure of the declining trend of competitiveness as measured by the degree of market concentration is given in chart 3 (Michie and Oughton, 2013).

Chart 3

Significant differences exist between financial and non-financial services and products:

- They are often not purchased frequently and hence the consumer has little experience or ability to learn from experience.
- There is no guarantee or warranty attached.
- Faults cannot be rectified.
- If the firm becomes insolvent during the maturity of the contract, the value of the financial product may be lost which is not the case with most other goods and services.
- Value is not immediately clear at the point of purchase: the consumer cannot know if a bad product is being purchased.
- There is a lack of transparency: it is difficult to verify the claims being made by the seller. Furthermore, it is often easy for a financial salesperson to

conceal relevant information and/or mislead the consumer. It is difficult to detect misrepresentation at the time of purchase.

- The full cost of the product may not be known at the point of purchase and it can sometimes be concealed from the consumer.
- It may be a long time (if at all) before the consumer is aware of the value and faults of a financial contract. This limits the power of reputation as an assurance of good products. Even if, in the long run, reputation is damaged by bad behaviour, consumer wealth is impaired in the meantime.

These characteristics mean that, in practice, the transactions costs for the consumer in verifying the value of contracts (even when this can be done at all) are high in the case of financial transactions. All of this means that consumer trust is more important in financial services than in most other industries.

Even though there may be many competitors in a market, competition is effective in practice only if consumers are able to:

(1) make rational and informed choices between alternative products and suppliers, and

(2) exercise these choices at low transactions costs.

There are many reasons why in financial markets consumers may not be able to make rational choices between alternative products, and also between alternative suppliers of the same product or service:

- not all relevant information may be available to the consumer at the point of purchase or be made explicit,
- information may be complex and opaque,
- products may be complex and difficult for the consumer to understand,
- trade-off calculations between different charges may be difficult to make even when information is made available,
- the structure of charges may be complex and difficult to understand,

- the full cost of the product may not be known at the point of purchase and it can sometimes be concealed from the consumer,
- suppliers may give emphasis to a particular “head-line” price which is only one component of the true cost of a product or service,
- suppliers may engage in “obfuscatory” pricing, i.e. pricing information that conceals the true cost of a financial product or service,
- it is often difficult for a consumer to judge the quality of a product at the point of purchase,
- The factors that determine the returns to the consumer of a particular product may be complex.

9. TRUST AND CONFIDENCE

Because retail financial transactions are fundamentally different from most other economic transactions, Trust and Confidence are essential in retail finance. Consumer trust is evidently more important in financial services than in most other industries. And yet trust in the industry is low and has been declining in recent years partly as a result of the crisis but also episodes of mis-selling of inappropriate products. The breakdown of trust in financial institutions, and the perceived way they conduct business and interact with consumers, can seriously lower the effectiveness of the financial system (Haldane, 2009).

Trust and Confidence are central when complex and long-term financial transactions are being purchased. But what precisely is meant by “trust”? The Oxford English Dictionary defines trust as follows: “firm belief in reliability, honesty, veracity, and justice; confident expectations; reliance on truth without examination; acceptance without evidence; confidence in honesty; person committed to one’s care, etc”. For our purposes, this can be re-formulated into a working definition of “trust” in financial services as follows:

> Confident expectations about good behaviour of a counterparty to an explicit or implicit contract over and above what is required by law and/or regulation. This includes that market power (whether by information advantages, the ability of post-contract behaviour of financial firms to change, etc) is not used against the

> interests of consumers and counterparties, and that consumers' reasonable expectations about good behaviour are satisfied.

It implies: keeping promises, predictable behaviour, and not adopting opportunistic behaviour.

Confidence, on the other hand, has three dimensions in finance: (1) with respect to the ability of a consumer to make rational decisions for future welfare, (2) confidence in particular financial products, and (3) confidence in the institutions supplying financial services and products most especially when they are high-value and long-term in nature. In particular, confidence is important with respect to three areas: *solvency, integrity* and *competence*.

Lack of Trust and Confidence can be regarded as a market failure for two main reasons: (1) there is likely to be a sub-optimal demand for financial products and services as some consumers exit the market, and do not buy what they should buy, and (2) conversely, inappropriate products may be purchased and therefore consumers end up with sub-optimal portfolios. There is a clear welfare loss if consumers buy inappropriate products perhaps because the product is willfully misrepresented or the consumer does not understand the nature of the product. Equally, there is a welfare loss if consumers do not buy suitable financial products because of a lack of Trust and Confidence in the products or their suppliers. In the current context, this could be particularly important if there is a need to give higher priority to long-term savings.

There are several things that can stand in the way of Trust and Confidence: potentially hazardous incentive structures within financial firms, evidence of deliberate lack of transparency and relevant information, rogue experiences, incompetence, etc. More specifically, there are several characteristics of financial products which mean that consumer trust and confidence are important and particularly when:

- contracts are incomplete as it is not possible to specify all future behaviour of counterparties in advance, and hence the outcome is uncertain,
- value is not immediately clear at the point of purchase: the consumer often cannot know if a bad product is being purchased,

- the outcome of the transaction is uncertain, and especially when the outcome can be determined by the behaviour of suppliers after purchases have been made,
- it is easy for a financial salesperson to conceal relevant information and/or mislead the consumer and when it is difficult to detect misrepresentation at the time of purchase,
- it may be a long time (if at all) before the consumer is aware of the value and faults of a financial contract. This limits the potential of reputation as an assurance of good products. Even if, in the long run, reputation is damaged by bad behaviour, consumers' wealth is impaired in the meantime,
- the outcome of the transaction is important to the consumer and s(he) has a lot to lose such as in the case of high-value transactions,
- exit costs are high,
- principal-agent relationships are involved,
- incentive structures are such that the counterparty can gain through bad behaviour,
- a long-term relationship is created by the transaction: relationships break down in the absence of trust,
- it is not possible for the consumer to learn from experience because the transaction is low-frequency,
- there is no guarantee or redress in the event that a contract or product fails in one way or another,
- the consumer requires advice when purchasing financial products, which gives rise to further potential principal-agent problems and moral hazard.

The central point is that there are significant differences between many financial products and services compared with non-financial products which means that the consumer needs to have trust and confidence in the solvency, integrity and competence of financial firms.

Trust and the mutual model

In many respects, mutuals should have an intrinsic advantage in Trust and Confidence not the least because they have “members” rather than exclusively customers. This means that consumers already have a firmer, more explicit, and higher level of relationship with the mutual than with other companies by virtue of "membership". This also means there is no conflict of interest between consumers and external shareholders. The corporate governance objective of a mutual is to behave in the interests of members rather than external shareholders. Although not all customers in a mutual are necessarily members, the distinction between owners and customers is less in a mutual than in other companies

Evidence from a variety of surveys suggests that consumers do in fact have more trust and confidence in building societies than in, for instance, SHV banks. Research conducted in July 2013 shows that customers of mutuals consider that their provider delivers on various aspects of service to a superior extent than do consumers at banks: being more trusted to act in their best interests, mutuals outscore banks by 17 pp; being open and honest, mutuals outscore banks by 11 pp; having high ethical standards mutuals have a superior score of 24 pp; in the area of treating customers fairly, the superior score is 10pp, and in being valued as a customer mutuals outscore banks by 16 pp. In terms of overall satisfaction, in mortgages mutuals have an excess score of 12 pp and in the savings market it is 10 pp.

An IMF study (Fonteyne, 2007) suggests that as consumer-owned institutions, cooperative banks have a comparative advantage in gaining the trust of their customers.

11. COOPERATIVE ARRANGEMENTS WITHIN THE MUTUAL SECTOR

A central feature of Cooperative banks in many continental European countries is that they have become linked in networks. As put by Fonteyne (2007): "quite a few networks have evolved into large, complex, financial conglomerates, some of which are now among the largest banking groups in Europe". Within this model, a key defining characteristic of cooperative institutions in continental Europe, especially in more recent times, is the increasing reliance on Central Network Institutions (CNIs), (Ayadi, *et.al*, 2011; Di Salvo, 2002; Desrochers and Fischer, 2005). These institutions grew out of various needs over time. One need, which has become increasingly important in recent years, was to centralize certain transactions in order to benefit from economies of scale.

In today's cooperative banking model in continental Europe, most local banks have left certain functions to such central institutions. These range from IT support to accounting, marketing, product development, treasury management, and risk management.

Several strategic and managerial advantages have been claimed for Cooperative banks forming networks between themselves which is the reason why Cooperative banks in many countries formed themselves into networks at an early stage in their development. Although the nature and degree of integration of networks, and the role of Central Network Institutions, vary between countries, amongst the most important advantages include:

- Economies of scale (and scope) most especially with respect to a range of back-office and administration functions. Through this route, relatively small banks are able to secure collective economies of scale that each is too small to generate internally. In this sense the network is analogous to outsourcing except that the contracts are held within the network and member banks maintain ownership and to some extent control which is not the case when outsourcing is conducted with third parties.
- In some cases (notably in The Netherlands) a CNI may perform the role of an internal central bank and intra network inter-bank market performing the role of intermediating liquidity in the network.
- Again in some cases, there may be the advantages both for the member banks and customers of mutual support.
- There may also be a management consultancy role performed by a NCI where best practice within the network can be disseminated.
- Member banks may also gain through the reputation and profile of the NCIs including that customers may have more confidence in banks which are known to be part of a credible network.
- A CNI may also have subsidiaries providing services for the benefit of both member banks and their customers which may not be feasible for individual member banks to directly provide themselves.

Today, CNIs serve these needs by providing a range of services. In most models, wholesale activities, such as the issuance of debt and (in some) the issuance of stocks is handled by network institutions, such as national or regional centrals. The extent of integration differs from one cooperative to another.

One particular aspect that helps distinguish stronger forms of integration from less official networks is the existence and the extent of mutual support or cross-guarantees available between different entities within a cooperative group. These systems range from a voluntary systems of support to more formal arrangements where one cooperative is legally bound to provide support to other cooperatives within the group, such as the case for Rabobank and Crédit Mutuel. An extreme form of support is the provision of joint-liability, available only for the Finnish cooperatives, which holds a cooperative directly liable for another's debt. In the case of The Netherlands, although all the member banks of the Rabobank Group are legally independent entities, the network's Cross Guarantee Scheme means that all member banks are liable for the obligations of all other members.

12. CAPITAL REQUIREMENTS AND BUILDING SOCIETIES

Two central issues arise with respect to a mutual's capital: (1) the regulatory minima that are imposed for safety and soundness reasons, and (2) access to new sources of capital. A potentially serious entry barrier in to retail banking is the prudential capital regime of the regulatory authorities. As noted by the Independent Commission on Banking in its Final Report:

> "The Commission therefore recommends that the PRA work with the OFT to review the application of prudential standards to ensure that prudential requirements for capital and liquidity do not unnecessarily limit the ability of new entrants to enter the market safely and grow. In particular, it should ensure that the use of the standardised approach does not penalize banks that are unable to transition to an advanced approach because of the high fixed costs of doing so."

Regulatory requirements

The Treasury has noted that:

> "the building society sector has historically been well capitalised and generally regarded as resilient enough to successfully weather the storms of an economic downturn" (*Reforming of Financial Markets*).

Indeed, before the collapse of the Dunfermline, there were only three building society failures in the previous fifty years.

There is one important respect in which mutuals differ from SHV banks. A requirement to hold more capital does not, in the main, imply that an SHV has to cuts its lending providing that the regulator stipulates that the higher required capital ratio has to be met by increasing the capital base. In this case, capital simply becomes an alternative to debt as a means of financing loans on the balance sheet. However, the case of mutuals is different because, with some minor exceptions, they are not in a position to raise external capital. This means that if a mutual is required to raise its capital ratio quickly, the only effective option is to reduce assets. The BSA has calculated, for instance, that if the equity capital ratio were to be raised from 3 to 4 percent, this would lead to a 25 percent cut in mortgage lending. Alternatively, it would take 7 years to generate the required increase in capital through profits.

A new regulatory feature in the Basel III Capital Accord is the introduction of a minimum leverage ratio. Under the old regime, the amount of capital a bank or building society was required to have was related to the sum of its risk-weighted assets. As mortgages (being judged to be low risk) were assigned a relatively low risk weight, this limited the amount of capital relative to total assets demanded by regulators for building societies. Under the new leverage ratio regime, in addition to capital requirements based on risk-weighted assets, there will also be a requirement to have a minimum leverage ratio calculated relative to the sum of total (not risk-weighted) assets.

Under Basel III, banks and building societies will be required to maintain higher levels of high-quality (equity) capital. The proposed 3 per cent leverage ratio would have a detrimental effect on building societies as they may be required to hold more capital against the same portfolio of assets which under the 'risk weighted assets' approach, attracted a low risk weighting. Not only is this problematic as they would face constraints in raising capital due to their mutual status, it is penalising an area of the banking market which was not responsible for the banking crisis. As noted above, and in the absence of external capital injections, in the case of mutuals a rise in required capital ratios is likely to be met by de-gearing.

The BSA has argued that a single leverage ratio across all business models is a blunt and inappropriate measure, and particularly damaging to low-risk businesses such as building societies and other mutuals. In contrast, differential leverage ratios, as favoured in the EU's Capital Requirements Regulation (27 June 2013), and agreed in principle by the European Council, would mean that building societies would not be unduly constrained from lending, and would be a more appropriate approach to capital requirement than a single one-size-fits-all higher ratio. As mentioned in the Independent Banking Commission Report, the Chancellor has noted the drawbacks of a single ratio, and the new Governor of the Bank of England has recognised that building societies could be disproportionately affected by a one-size-fits-all higher ratio.

New capital

The almost only sources of capital for a building society are retained profits, Preferential Interest Bearing Securities (PIBS), and very recently Profit Participating Deferred Securities (PPDS) although there is some doubt about whether the last-mentioned will qualify as Core Equity Tier 1 capital under CRDIV. The Treasury is working closely with the sector and the regulatory authorities to ensure that there is due provision in CRD4 for an instrument that reflects the nature and reality of mutuality and which will enable mutuals to raise more capital. This is to be greatly welcomed.

The limited access to external capital limits the potential of building societies to expand and most especially with respect to acquisitions. There is a need to expand the range of options for building societies to raise capital from existing and new members in a way that does not detract for the central concept of mutuality. In many other countries (notably Netherlands and Canada) mutual banks have considerably more scope to raise external capital than do building societies in the UK.

In 2009, the Financial Services Authority announced in 2009 a new instrument for the building society sector – Profit Participating Deferred Shares or PPDS – allowing capital to be provided in a way that carries modest servicing costs to begin with but can deliver a fair overall return in the long term. The issuing mutual will use a proportion of its annual profits to pay distributions to holders. Nationwide has plans to issue PPDRs in order not to raise new capital but to replace debt capital that will no longer be classified as Core Tier 1 Capital.

In July of this year, Lord Naseby presented the Mutuals' Redeemable Share's Bill, which would create a legal framework for all mutuals to raise capital through redeemable shares. It aims to create an optional class of redeemable shares through which specified mutuals can raise additional funds. Such capital instruments are used by mutuals in Canada and The Netherlands. The Bill is awaiting its second reading in the House of Lords. This Private Members Bill would create a legal framework for societies registered under the Industrial and Provident Societies Act 1965, the Friendly Societies Act 1992 and a mutual insurer registered under the Companies Act 2006, to raise capital through redeemable shares. This represents the first time that societies registered as corporate bodies under the Friendly Societies Act 1992, would be permitted to issue shares.

13. RING FENCING

Following the recommendation of the Independent Commission on banking (Vickers Report), a ring-fencing regime will be put in place which implies that, when a bank conducts a range of retail, wholesale and investment banking activities, the retail part is to be ring-fenced (with dedicated capital) and not contaminated by problems that may arise in other parts of the business. Ring Fencing requires that ring-fenced activities are to be conducted through a separate subsidiary (with its own dedicated capital) and clearly separated from another subsidiary conducting non-ruing-fenced activities.

In practice, building societies are already effectively "ring-fenced" institutions as he Building Societies Act already subjects societies to legislative restrictions: at least 75 percent of a building society's loan book must be in the form of mortgages.

Although building societies are to be exempt from ring-fencing requirements are laid out in the Financial Services Bill, clause 8 gives the Government the power to amend the Building Societies Act to bring it in-line with the ring-fencing rules for banks.

The Reform Bill proposes a *de minimis* exemption from ring-fencing for small banks with less than £25 billion of deposits from individuals and SMEs. The purpose of this is to avoid small banks facing disproportionate costs as a result of ring-fencing, which could impede their availability to compete and grow, and could deter new banks from entering the market. The government proposes no *de minimis* exemption for building societies. Under the proposed reforms, although banks with less than £25 billion of specified deposits will be exempt from ring-fencing, building societies of the same assize or smaller will still be subject to any ring-fencing amendment to the Building Societies Act.

However, if the same *de minimis* exemption were to be applied to building societies through amendments to the Building Societies Act, all but two building societies would probably be exempt. There is therefore a potential competitive disparity if large to medium sized banking groups are not subject to ring-fencing legislation, but a building society of equal size is subject to ring-fencing via an amended Building Societies Act.

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14. LEGISLATIVE CHANGE

Legislation regarding mutuals and cooperatives is spread across many different statutes created at different times, and some mutuals are also registered under the Companies Act. Each piece of legislation is a product of its time which means that in many cases they are outdated and do not reflect current conditions, they may also be inconsistent with each other, are not competitively neutral between different parts of the mutual sector, and are not always consistent with changes in the Companies Act.

Whilst some useful reforms have been made to the legislative basis of the various parts of the mutual sector, there has been no substantial amendment to the Building Societies Act since 1997. There is an urgent need for comprehensive and integrated reform to bring the legislation in a way that reflects current conditions and to remove some of the legacy distortions of the current suit of Acts. The review of all mutuals and cooperatives legislation needs to be as fundamental as, for instance, the review of building societies legislation after a Green Paper lead to the 1986 Building Societies Act.

It is, therefore, gratifying that the Coalition Government has stated a commitment to consolidate the more than a dozen out-of-date pieces of legislation governing cooperatives and mutuals into a single statute. In the Reforming Financial Markets document, the Treasury stated that reform was part of the government's commitment to competitive markets and that it's planned reform "will strengthen the ability of mutual societies to compete in future".

In 2012, the Government announced its intention to introduce a Co-operatives Bill that would consolidate the several outdated pieces of legislation governing co-operatives and mutuals into a single statue. The current legislation is complex and outdates; it exists in 17 separate pieces developed in piecemeal since 1965. A consolidation Bill on Co-operatives was confirmed by the Leader of the House for the legislative year of 2013-14, which would consolidate the 17 existing pieces

Several principles should guide the construction of legislative reform. It should:

- reflect current competitive conditions in the market place,
- be competitively neutral as between different sectors in the financial system and most especially between mutuals and SHV institutions,
- make it easier to form new mutuals,
- enable mutuals to play a greater role in the economy and in delivering public services,
- allow a more diversified range of financial services and types of loan to be provided by the mutual sector,
- allow all types of mutuals to merge with each other as envisaged in the Butterfill Act.

Whilst some reforms have been made, recent initiatives over mutual reform have come from different areas of Government, leading to a lack of continuity and overall plan. Reform would be made easier if there were to be a dedicated "Minister for Mutuals" (probably located within the Treasury) who would oversee the development of policy across government, and also be responsible for enhancing and monitoring diversity in the financial system.

Similar issues arise elsewhere in Europe. At EU level, the European Parliament recently adopted a report with recommendations to the EU Commission on a Statute for a European Mutual Society. This is in response to difficulties experienced by mutuals across Europe on account of the lack of any existing legal framework in certain member states and of the difficulty in forming alliances with other mutuals. This would aim to promote the mutual model, create a level-playing field for all entrepreneurial forms and statutes, enable cross-border and trans-national activities and give mutuals a European legal instrument to develop their activities.

With regard specifically to Friendly Societies, originally introduced in 1974, the Friendly Societies Act was updated in 1992, but it was rushed through its Parliamentary stages in only three weeks in the lead up to the 1992 general election. Therefore, the Act lacks coherency being a mixture of provisions from the Building Societies Act 1986, the Provident Societies Act 1965, and the Companies Act 1989. It partly consolidates earlier legislation but fails to do so comprehensively. Subsequent Acts of Parliament and statutory instruments have repealed and replaced parts of the Friendly Society Act and the Industrial and Provident Societies Act.

Efforts must be made to ensure that Friendly Society legislation receives the same attention and focus as that relating to co-operatives.

Legislators could use the Companies Act as an example of how to achieve this; the 2006 Companies Act was a consolidating statute for company law, coming more than 20 years after the last major revision of company legislation. The time has come to consolidate, streamline and modernise all law whilst at the same time maintaining the distinctive features of different types of mutuals. In other words, sustaining existing diversity within the mutual sector is as important as enhancing diversity as between mutuals and SHV institutions.

Mutuo's *Mutuals Manifesto* (2010) correctly argues that "the current approach puts mutuals at a competitive disadvantage, where they often have to wait many years to enjoy the same benefits as companies". Government should commit to ensure that in future, all mutuals and co-operatives are treated equally with companies in maintaining and improving their legislative environment

15. THE PROTECTION GAP

Given the complexity of many financial products, easy access to independent financial advice is important if consumers are to have trust and confidence in their financial dealings.

Prior to 2013, IFAs were remunerated in one of two ways: by commission payments from product manufacturers, or by charging up-front fees to the consumer accompanied by passing on any commission received. Commissions were ultimately paid by consumers in the form of deductions from the value of the investment made. The obvious problem attached to commissions is two-fold: the incentive structure faced by the IFA who might be tempted to recommend a product on the basis of the amount of commission received, and because (notwithstanding the requirement to disclose commission) in practice there was a lack of transparency.

The introduction of Stake-holder Products (simple products with defined characteristics) and CAT standards only marginally alleviated the complexity problem and, therefore, the need for advice.

In January this year, new rules from the FSA came into effect which has changed the way financial advisory companies operate. Known as the Retail Distribution Review (RDR), the objective is to raise professional standards in the industry, introduce greater clarity between the different types of services available, and to make the cost of advice clear and explicit. However, there is debate over whether these new rules will create a 'post-RDR protection gap' (especially for low/middle-income consumers) as the new regulations will reduce the number of high street advisors and encourage a focus on more wealthy clients. Many firms have switched to an "information only" service. With advisors no longer able to receive commission, they will charge a regular set fee and are likely to choose clients who are able to afford these upfront. With these new rules, lower or middle class earners will either find it harder to receive advice or will be fully excluded. This could result in some consumers buying inappropriate products and/or not buying products that would suit their needs. RDR rules also enforce tougher rules for qualifications, a move that has already seen a number of banks cease to provide independent financial advice, causing many big names on the high street to cut back on face-to-face financial advisory services, or withdraw them altogether. For example, RBS blamed the new rules for its decision to cut 618 advisor jobs, Lloyds TBS stopped face-ta-face advice for anyone with less than £10,000 in assets, and HSBC cut 700 staff owing to the new rules.

This clear gap in the market could be filled by mutuals where the evidence indicates that they are more trusted than many other financial firms although, as it happens, not brokers.

16. SHARED OPERATING MODELS

Across Europe, Cooperative Banks are often (though certainly not always) are small and not sufficiently large to generate economies of scale internally. This is certainly true of most building societies. An earlier section drew attention to the important role that central network Institutions play in most Cooperative Bank models in Continental Europe. A further example is the role of the Credit Union Service Corporation in Australia which provides a range of services to (sometimes very) small credit unions across Australia. In fact, the UK is alone in not having such a CNI although some Societies have outsourced some function within the mutual sector to other building societies.

The sharing of back office functions (such as IT systems and administrative duties), and the pooling of funding, is an option to be considered by smaller building societies in order to achieve benefits of scale.

There are two main approaches (other than outsourcing to third-party providers of services) to sharing operating models:

1. *Leading society approach*: A Society takes responsibility for providing outsourced and shared support functions to other societies. Newcastle Building Society, Yorkshire Key Services and Skipton's HML subsidiary provide administration and IT services to several smaller societies.
2. *Transfer functions approach*: functions are transferred or outsourced to a separate legal entity jointly owned by participating societies. For example, MutualOne business is majority-owned by the Skipton Building Society and provides IT services to some 17 building. Whilst there is an increased

administration cost burden involved in establishing a separate legal entity, this may well be offset by the cost saving possibilities.

If sharing arrangements are established, societies would have the opportunity to consider further ways in which they could collectively benefit from economies of scale, such as joint covered bond or securitisation programmes for mortgage assets, cheaper access to wholesale funding markets and the opportunity to jointly purchase larger mortgage books which would otherwise be out of reach.

In 2010, an expert group commissioned by the Government, explored pooled funding models and noted that societies could gain access to new (or more affordable) sources of wholesale funding by issuing covered bonds through an issuing entity jointly owned by a number of societies.

The key is to allow small mutuals to achieve or enhance competitiveness and economies of scale whilst at the same time retaining their independence and distinctive competitive features. Furthermore, societies with shared facilities might be in direct competition with each other in the same market place. In the final analysis, the objective is to secure economies of scale for small societies which are not big enough to generate them internally.