Building Societies Association

Perspectives: Governance in building societies

Opportunities and challenges of the inter-generational business model


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Abstract

Many of the commercial disciplines of running a building society are similar to those facing banks and other shareholder owned businesses. However, the context is different. Founded from a social purpose, with a long-only (inter-generational) horizon and experiencing both the benefits and challenges of customer ownership, building society boards need to look through a different lens. This paper explores some of these important themes.

Introduction

At an informal dinner with building society non-executive directors the discussion turned to what they meant by the long term. Initial reactions were based on their societies having three to five year business plans. Followed-up almost immediately by an exploration of how the commitment to running an inter-generational business can be reconciled with such a short-term planning horizon. And how it is possible to do anything more meaningful about the long term in a business environment and world that is changing so rapidly.

This article continues that exploration, starting with a discussion of the relevance today of businesses founded from and pursuing a social purpose, leading to the idea of stewardship and member value, and some of the specific aspects of governance that challenge boards.

The importance of exploring social business purpose

So much of our thinking and understanding around the governance of UK businesses is based on the UK Corporate Governance Code (Financial Reporting Council, 2016) and the broad body of work and experience that has grown up around the management of shareholder owned businesses. From its earliest days as the Cadbury Code (Committee on the Financial Aspects of Corporate Governance, 1992), the UK Corporate Governance Code has been designed for listed companies. Other types of business have variously been encouraged to adopt the principles of the Code. Building Societies are no exception, with the BSA's Annotated Code (Building Societies Association, 2016) published to assist boards in understanding and reporting on their degree of compliance under the PRA Rulebook (Prudential Regulation Authority, 2015).

However, the Code is designed for listed companies. One of its most obvious shortcomings or weaknesses is that the fundamental purpose of shareholder owned businesses (to deliver returns or value to shareholders) is just assumed.

Building societies, along with other customer-owned financial mutuals, have a fundamentally different purpose, summarised simply as delivering value to members. How that value is defined is a far more complex issue and goes back to the very foundations of the building society movement in the 18th century. To over-simplify, the earliest building societies were a product of the industrial revolution – a period when the population was increasing and towns and cities were growing rapidly as workers came from the rural economy to fill the factories and mills.

Herbert Ashworth (Ashworth, 1980) describes the workers in the towns being far more vulnerable when illness or unemployment occurred. Deprived of the traditional family and community support that characterised rural life, they started to found Friendly Societies from the 1750s. Other types of mutual association, including savings clubs, followed and, around 1775, there are the first references to mutual terminating building societies, starting with Ketley's in Birmingham.

The fundamental purpose of the original building and friendly societies – to enable members to save for their futures and provide them with their own home, their own welfare provision, their own security, is largely unchanged in today's building societies and financial mutuals. The UK's building societies are the UK's largest network of membership organisations, with over 23 million individual members (Mayo, 2017).

In a highly competitive savings and mortgage market, we believe It vital that today's building societies use their deep understanding of their purpose (often their social purpose, the reason they were created in the first place, the problem they were created to resolve) to stand out from the rest of the financial sector.

The City Values Forum and Tomorrow's Company talk about purpose as an expression of why organisations exist, beyond financial gain, the impact they want to have on the lives of everyone they wish to serve. *"Purpose should inspire people so that they want to be part of the organisation – as employees, customers or suppliers"* (City Values Forum and Tomorrow's Company, 2016).

That deep understanding provides a powerful guide or framework for successive leadership teams, continually developing the organisation to meet the demands and challenges of a rapidly changing world, whilst remaining true to the founding principles.

It also provides a clear point of distinction in a crowded market place. The better building society boards and management teams understand why their organisations are here, the clearer they will be about their strategic direction and how they respond to the opportunities and challenges that come their way. In short, the better the judgements and decisions that boards and management teams will make.

This is not about living in the past. It is about each building society looking back to its own foundations (and that of similar businesses) as a source of inspiration for how they do business today, how they define their objectives, and how they stand apart from the rest of the banking and financial services sector - for the right reasons.

Stewardship and member value versus shareholder value

"Remember that you did not inherit the earth – but are merely custodians for your children and grandchildren." North American Indian saying

Let's start with the profit motive. Building societies are "for profit" organisations. Profit is a good thing. It is the means by which mutual businesses build capital to support more lending. However, societies are profit optimising organisations, rather than maximising, and perhaps can claim a greater focus than some other businesses on how they make their money.

There is a long-running debate in the building society sector about the idea of the mutual dividend – how much societies give back to members, and how they do that. For example, in its 2017 Annual Report, Nationwide Building Society quantified the amount of profit (£505m) that it had decided to give back to its members through saving and mortgage rates (Nationwide Building Society, 2017).

This is a specific example of an equation that the BSA often discusses with its members: if a properly functioning and profitable bank distributes roughly 30% of its post-tax profits to shareholders in the form of dividends, what do building societies and credit unions do with their equivalent profits?

Research by Casu and Gall (Casu & Gall, 2016) importantly confirms that building societies are as efficient as banks, making the starting point for the discussion valid. Broadly, it can be argued that building societies apply the mutual dividend in three ways:

- Some might be returned to the members through rates per the Nationwide Building Society example;
- Some might be retained by the business to add to reserves, recognising the difficulties mutual organisations face in raising supplementary capital and the need, therefore, to adopt conservative capital policies; and
- Some might be invested in the organisation's community as an integral part of its strategy – and increasingly this is being seen as including local branch networks.

Following on from that, let us think about the co-operative principle of indivisible reserves. The building society is owned by its members, but no individual member has the right to call on their share of accumulated reserves. The philosophical rationale behind indivisible reserves is that a co-operative is seen as an inter-generational enterprise. The reserves accumulated by former members do not legitimately belong to present members only, and the reserves accumulated by the present members are also not exclusively their property, but are an investment in future members as well (Roelants, 2012).

This was a principle trounced by the demutualisations of the 1990s. The members of the day took the accumulated profits from previous generations – the endowments if you like – for themselves.

The justification at the time was that the building societies had become fat and complacent; that their accumulated capital could be put to better and far more effective use in the plc world. This was fundamentally, and perhaps wilfully, to misunderstand the different nature of mutual businesses. None of the demutualised building societies have survived as independent banks.

And that brings us to the particular question of stewardship for the financial mutuals – the opportunities and challenges that mutuals rather than shareholder structures provide. The singularity of purpose – to pass the organisation on in a better state than you found it, fulfilling our social purpose for the current generation while laying the foundations for a strong and vibrant future.

Kay suggests that traditionally there may not have been a great difference between the shareholder owned corporation run for the long term and the co-operative or mutual business. But the rise of "financialisation" since the 1980s has created a whole series of new pressures on corporations to maximise value in the short term, in conflict with and at the expense of long term stewardship (Kay, 2015). The absence short term activist shareholders in the mutual world enables building societies and others to continue to pursue inter-generational strategies.

One of the biggest challenges for all mutual boards, then, is balancing the needs of the current generation of members through rates and dividends while building the strength, capacity and resilience of the organisation for future generations. How do you get that balance right? What are the judgements you have to make? How do you know (or even draw comfort) that you are getting it about right? What does right look like?

Customers as owners

One member, one vote is a fundamental tenet of the co-operative and mutual movements, stemming from the second Rochdale Principle:

> *"Co-operatives are democratic organisations controlled by their members, who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership."*

There is a commonly held view that today's customers of building societies have no concept of mutuality, no concept that they are members of the building society and what that means. This is particularly the case with savings members who come via the internet rather than in branch, and the 70-80% of mortgage customers who come via intermediaries. The £85,000 deposit protection provided automatically under the Financial Services Compensation Scheme removes most of the skin in the game for savers – they experience little or no moral hazard. Borrowers often just want the cheapest deal.

It is pleasing to see a number of building societies, most notably Nationwide Building Society, because of its sheer size, leading a drive to raise the profile of building societies as customer owned mutuals and clearly distinctive from shareholder owned banks.

Nonetheless, the general lack of awareness among members that they are members plays out further in the inherent weaknesses of the one member: one vote system as an effective form of control of the business and the management by the members. This themes is dealt with in more detail elsewhere (Excellent and distinctive governance in building societies, Brian Morris & John Heaps), but places a very real responsibility on the board to demonstrate a high level of self-accountability to the membership; to seek out and engage members actively in the affairs and development of the society; and to think consistently and deeply about delivering tangible member value.

Strengths and weaknesses

We have talked about the advantages of the mutual model, especially the ability to play the long-only game. We turn now to some of the major challenges. Llewellyn and Holmes (Llewellyn & Holmes, 1997) identified three common criticisms of the mutual form of business:

1. The objectives of a mutual are difficult to define, and are ambiguous;
2. There is a serious corporate governance deficit in that the wide dispersion of ownership rights means that management is insufficiently accountable to owners, and the monitoring of management is weak; and
3. The absence of tradeable ownership rights means that the management of mutuals is not subject to the discipline of the capital market through the signal effects of share price movements, and the market in corporate ownership and control.

The first two of these points have been addressed in the preceding paragraphs. The third is about complacency risk - Boards and Management Teams becoming rather too comfortable with life, particularly in benign trading environments.

Many openly recognise that it has been possible in the past to get away with doing a pretty average job for a long time with little danger of being found out. The absence of activist shareholders breathing down your neck is a virtue for the sector in many ways, but demands the boards find other ways to ensure that they and their executive teams are kept on their toes. This challenge can be characterised in one regard as delivering steady organic growth (8-10%) year in and year out with real energy and vigour in good times; and of refusing to accept lame excuses and explanations that it will all come right given more time, that market conditions are challenging, that regulators are constraining the business. And in genuinely hard times such as the 2008 financial crisis, hunkering down and riding out the storm.

It takes a certain type of individual who is excited by the steady organic growth model; who takes real satisfaction from seeing the business double in size every 10-12 years; who knows when to strive for growth, and when to back off; who avoids chasing the peaks of the market.

A 2016 survey by Independent Audit highlighted the very significant influence that the CEO and senior management of a building society have on the firm’s culture, and the key responsibility of the Board, therefore, to appoint the right individuals to these senior roles (Independent Audit, 2016).

CEO engagement with board and Chairman

"*The secret of good governance in co-operatives is to take it seriously, to invest in it, learn how to do it, and over time to test, prove and improve governance and business performance."* (Birchall, 2014)

Since the 2008 financial crisis, building society boards have been through a period of significant change, in many cases strongly encouraged by the Prudential Regulation Authority. Very long-serving NEDs have retired; priority in recruiting new directors has been focused on strengthening financial services and risk management expertise around the board table; and more frequent rotation has become the norm, usually based on a 6-9 year maximum term.

The BSA / Odgers Berndtson 2015 report on Building Society Governance (Building Societies Association and Odgers Berndston, 2015) stated that the relationship between Chair and CEO is seen as key: it should be constructive but not too close, with well-defined clearly delineated roles for each. The report goes on to talk about the need to encourage constructive challenge. But there was a feeling among board members that regulators' obsession with the need for NED challenge may have gone too far – that some NEDs were feeling compelled to challenge even on matters where they felt there was no need.

Two years on and ten years on from the beginning of the financial crisis, there is a sense that building society boards have come to terms with the new operating environment. The challenges are better understood, including:

- New CEOs, new boards, shorter tenures, many coming from outside the sector, bringing new perspectives and fresh thinking, but some without mutual business experience
- Boards seeking to ensure sufficient time for business strategy and future development in the face of heavy regulatory and compliance demands
- The importance of NEDs remaining non-executive.

One essential constant that remains unchanged is that *"good boards are created by good chairmen"* and that an essential role of the chairman is to develop productive working relationships with all executive directors, and the CEO in particular, providing support and advice while respecting executive responsibility (Financial Reporting Council, 2011).

The pressure for governance transformation in recent years emphasises the importance of the strength of the organisation and organisational culture that sees the business through such a rate of senior management change whilst remaining true to its purpose and values.

Whilst many new executive and non-executive directors have spent earlier parts of their careers in the building society and mutual world, many have not. The process for introducing new board members who do not have a deep understanding of the mutual purpose of the firm becomes critical. The chairman and CEO have, in our view, a particular responsibility here – to encourage challenging and innovate thinking from all board members, new and established, whilst ensuring that the whole board have a proper understanding of the dynamics of a mutual business.

Given the critical importance of CEO appointments, the same is true when boards appoint new leaders for their societies. Dan Ciampa (Ciampa, 2016 (December)) states that a third to a half of new CEOs fail within their first eighteen month and highlights that the journey does not end with the handshake sealing the appointment. Whilst the historic failure rate among new building society CEOs is considerably lower, it is still vital during the early weeks and months for both the new CEO and individual board members, most importantly the chairman, to reach out to each other to ensure that the formal induction process follows through into a much longer transition period as both the organisation and the new appointee get the proper measure of each other.

Relationships firmly established in the early days of a new appointment, executive or non-executive, lay the foundation of trust and respect that is so important to the proper function of board.

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