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Batiz-Lazo, Bernardo and Billings, Mark

University of Leicester, Nottingham University Business School

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Comparative performance of UK mutual building societies and stock retail banks: further evidence: a comment

Mark Billingsa, Bernardo Bátiz-Lazob

aNottingham University Business School, University of Nottingham, Nottingham, NG8 1BB, UK
bSchool of Management, University of Leicester, Leicester, LE1 7RH, UK

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Abstract

Shiwakoti et al. (2008) concluded that four of the largest UK mutual societies which converted to listed bank status in 1997 outperformed, on a variety of measures, those societies which did not convert in the four-year periods both before and after conversion. All four converting societies have since been subject to ownership change, suggesting that this out-performance failed to persist, or was perhaps illusory. We do not criticise the results obtained by the authors, but suggest that they leave unanswered important questions, such as how to measure ‘superior’ performance and the appropriate time frame over which to evaluate this.
1. Introduction

In one of several linked papers on UK mutual building societies, Shiwakoti et al (2008, hereafter SKH) investigated the performance of UK mutual building societies and stock retail banks in the period 1993-2000, which covers four years before and four years after the conversion of four of the largest societies to banks listed on the London Stock Exchange in 1997. SKH concluded that these societies (hereafter ‘the converting societies’) outperformed those societies which did not convert (hereafter ‘the continuing societies’) in both pre- and post-conversion periods on a variety of measures. This is a striking conclusion, as all four converting societies have since been subject to ownership change, suggesting that this out-performance failed to persist, or was perhaps illusory.

We do not attempt to present a full assessment of the building society sector in this comment, but we suggest that SKH’s analysis, although welcome, suffers from significant shortcomings. We do not criticise the results obtained by the authors, but we raise issues over the methodology used and interpretations of the results. We therefore suggest that SKH’s findings leave unanswered important questions, such as how to measure ‘superior’ performance and the appropriate time horizon over which to evaluate corporate performance.

The measurement of long-term business performance is undoubtedly difficult. Financial crisis has shaken the existing order in the financial sector and market conditions have changed dramatically since the article was accepted and published. Of SKH’s sample, most of the 40 continuing societies (SKH, pp. 335-336) still exist as
independent entities, but all of the four converting societies have been subject to ownership change (see Table 1). While successful performance may be defined in different ways, such a fate does not seem one of these. [INSERT TABLE 1 HERE]

The remainder of our commentary is structured as follows. We next discuss demutualization, mergers among building societies and comment on the impact of the current financial crisis. We then consider SKH’s performance measurement and their interpretations. Finally we draw conclusions.

2. Building societies, demutualization, mergers and financial crisis

In the current financial crisis mutual building societies seem to be viewed with a certain nostalgia and mutuality is suggested as a model for financial institutions going forward. In this comment we do not argue for the theoretical superiority of any particular organizational form, and analysis of the mutual form reveals both advantages and disadvantages (SKH, pp. 320-322). Whether these translate into ‘superior’ performance, however measured, is an empirical question and studies such as SKH are therefore important and welcome. Inevitably, the results of the analysis will be sensitive to the selection of time period and performance variables. Before we review SKH’s analysis we consider demutualization in the UK building society sector.

We do not argue that demutualizations cannot produce gains for the organizations themselves or their members. The arguments are well-rehearsed, and although SKH’s analysis tells us nothing about the position of the members of converting or continuing societies, this is not their objective. Demutualization
unlocked value for members by giving them free shares. This provided a means of selling their ownership rights, thereby crystallizing the otherwise intangible value of membership through their ability to trade shares and receive dividends. Many societies attracted ‘carpet-baggers’ who became members in anticipation of these potential benefits of demutualization. But members of continuing societies may have benefited from preferential terms offered by their societies. A full analysis of the relative gains from membership of the converting and continuing societies has yet to be carried out and would need to include a comparison of potential returns to shareholders in converting societies and the potential benefits to the members of continuing societies could have enjoyed as investors and/or borrowers.

In SKH’s account, demutualization of building societies can be explained in terms of the inability of these institutions to grow further within their sector, including constraints on management recruitment and remuneration arising from societies’ traditional reliance on internal labour markets. Effectively the large converting societies had outgrown the movement, and anticipated demutualization by beginning to adapt before this took place. But whilst different from other societies, and apparently prepared for proprietary status, their subsequent failure to secure long-term survival suggests an inability to adjust fully to their new status. This is consistent with the findings of Shiwakoti, Ashton and Keasey (2004) (SAK), who demonstrate that higher executive remuneration in converting societies did not reflect superior performance (on a more limited range of measures than used in SKH). With hindsight, demutualizations allowed managers to gain greater control over both sides of the balance sheet and this created opportunities for growth which translated into higher remuneration. Growth opportunities for financing owner-occupation, the main
lending activity of building societies, were limited, and other forms of lending, such as buy-to-let and commercial lending, offered better growth opportunities as the economic cycle became more favourable.

There is an extensive literature on mergers and economies of scale among building societies (summarized by Drake, 2003, pp. 310-313; also see, for example, Haynes and Thompson, 1999, pp. 833-834). Drake (2003, p. 314) finds that economies of scale in larger societies had not been exhausted by the time the converting societies demutualized. There therefore remained potential gains from organic growth or participation in mergers involving such societies. So why did the converting societies choose to convert, rather than try to reap such gains, as the largest continuing society, Nationwide, appears to have done? SAK may have provided the answer (higher remuneration) and it is possible that the converting societies may have performed better in at least some respects if they had chosen not to convert but pursued alternative strategies. But mergers between mutual organizations face many of the same difficulties as combinations among non-mutuals, and in particular incumbent managers may represent a formidable barrier to hostile takeovers.

We have noted the demise of the converting societies, but we also observe that continuing societies have experienced significant difficulties during the current financial crisis. Some societies suffered losses through placing deposits with Icelandic banks, several appear to have been imprudent in commercial property lending, and all have been obliged to make additional contributions to the Financial Services Compensation Scheme to compensate depositors in failed banks (KPMG, 2009). This has revived a long tradition of an implicit guarantee within the building
societies movement for larger societies to merge with smaller financially weak societies in ‘rescue mergers’ (see Thompson, 1997, for a discussion of merger motives). Consolidation within the building society movement has continued since 2000 and at the time of writing the number of societies had fallen below 50 with the prospect of further mergers. In the post-crisis consolidation the largest society, Nationwide, has absorbed several smaller societies - the Cheshire, Barnsley, and Dunfermline societies. Britannia has merged with Co-operative Financial Services to create a ‘super-mutual’, a merger between the societies ranked second and third in size, Yorkshire and Chelsea, is proceeding, and mergers of smaller societies have taken place (KPMG, 2009).

We also note in passing that SKH consider demutualization in British building societies in isolation from other mutual experiences, including those of other Anglo-Saxon countries, such as Australia and New Zealand, where demutualization of significant financial institutions took place during a similar period and perhaps as fast as in the UK. Elsewhere, there are barriers to demutualization such as shared assets or a central clearing house or central provider of services (for example, among the Spanish savings bank and Rabobank in the Netherlands). We acknowledge that these experiences are outside the scope of SKH, but suggest that demutualization is a complex phenomenon.

3. Performance measurement
In this section we suggest three areas in which we believe SKH’s analysis suffers shortcomings: the choice of risk measures; the time period; and the sample of societies covered.

3.1 Risk

Is it possible that increased risk contributed to the loss of independence of the converting societies, and, if so, why was this not reflected in SKH’s results? There are two possibilities: either the chosen risk variables failed to capture important aspects of risk; and/or risk did not increase until after the period of study. We now address the first of these points and consider the second in the next sub-section.

SKH’s risk ratios fell in both sub-periods (1993-96, 1997-2000) for both converting and continuing societies and there were higher levels of risk in the converting societies in both sub-periods (SKH, p. 326). The second finding is unsurprising - the converting societies were larger, faster-growing and diversification allowed them to take on more risk and the desire to grow rapidly would have encouraged them to do so. SKH (p. 331) argue that ‘risk taking should increase following the conversion from mutual to plc status’, yet on these measures it falls. But the two chosen risk measures, the ratios of loan loss reserves and provisions for loan losses to total assets, are both lagging indicators of credit risk. Risk should have increased as the converting societies moved (further) into business areas such as commercial lending in which they had less experience and lower quality security may have been available. In the absence of superior skills, converting societies were presumably likely to acquire more marginal borrowers. SKH (p. 331) suggest caution
and attribute the improvement in the risk ratios to falls in loan losses in the 1990s as the economy emerged from recession. This immediately raises the question of the extent to which the chosen risk measures capture a cyclical effect and are not attributable to the behaviour of the institutions.

We suggest that a wider range of measures is necessary for a more thorough assessment of risk. SKH treat growth in assets as a positive indicator of performance. We suggest that it could just as easily be considered a leading indicator of risk, as institutions growing more rapidly than the industry average would presumably acquire lower quality assets at the margin. We acknowledge that the more rapid growth of converting societies could be attributed to superior management skills, or the ability to exploit economies of scale (although differences in growth rates between the converting and continuing societies virtually disappeared post-conversion: SKH, p. 325). It is also possible that greater risks were taken in order to drive growth - risks which ultimately were either misjudged or ignored and are not reflected in SKH’s analysis. The reliance on wholesale funding of some converting societies to drive balance sheet growth has become evident in the financial crisis and we note that SKH do not include any liquidity measures in their analysis. Schrand and Unal (1998), for example, suggest that a simple measure of risk in institutions converting from mutual to stock ownership is unlikely to capture total firm risk, given the complex dimensions of risk faced by financial institutions. Converting institutions may choose, for example, to make greater use of derivatives to manage interest rate risk, which allows them to absorb increases in other risk measures.

3.2 Time period
We suggest that it would have been preferable to present results over various periods to see whether they are sensitive to the choice of period. SKH consider a period of eight years, of which four are pre- and four post-demutualization. They do not provide an explicit justification for their choice of time period and one can question the choice of both start and end points and the length of period. Why not take a longer period, such as a total of 10 or 15 years? We do not imply that the period was deliberately chosen to produce particular results, merely that the appropriateness of any particular period is unclear. In fact, SKH’s end point is not arbitrary - there is a good reason for limiting the post-conversion analysis to four years, as it is after 2000 that the converting societies begin to disappear as independent institutions. Thus the chosen end point could represent a clear step change in the adaptation to life as listed banks.

SKH offer no explicit justification for the starting point, although it could reflect structural or strategic change within larger societies. An implicit reason for selecting 1993 as a starting point is that this is the end point for the analyses by Haynes and Thompson (1999), Thompson (1997) and Valnek (1999). But there is every likelihood that the divergence between converting and continuing societies began before 1993 - the Building Societies Act was passed in 1986 and the Abbey National was the first society to demutualize in 1989. 1986 and 1989 would both therefore appear obvious starting points for analysis, and one could argue for an earlier date on the grounds that the largest societies which eventually demutualized would have anticipated the legislative change before it actually took place.
3.3 Basis of sample

We question whether SKH’s sample offers an appropriate basis for the performance evaluation they undertake. We would argue that some of SKH’s measures should not be used to compare converting and continuing societies at all. SKH (p. 331) find superior performance on profitability measures for the converting societies, but claims for the superiority of mutuality are not founded on higher profitability. Indeed, in preparing for conversion it would be remarkable if the converting societies did not show superior profitability. Unfortunately, the obvious counter-factual - to examine continuing societies with similar characteristics to those converting - is not available.

SKH ignore 27 of the continuing societies on the grounds that due to their small size they cannot be reasonably compared to the converting societies (SKH, p. 323, footnote 1). If one accepts this argument, then why compare the 20 or so continuing societies with assets of less than £1 billion to the converting societies, the assets of the smallest of which were more than 20 times this (SKH, pp. 335-336)? This seems an entirely arbitrary decision.

4. Conclusions

Demutualization raises many interesting questions. We do not suggest that it is easy to conduct the type of analysis undertaken by SKH and it cannot answer some of the most interesting questions, such as why some societies chose to demutualize and others did not, and the timing of such decisions. But other questions, such as at
what point do the performances of converting and continuing societies start to diverge, could be answered by this type of analysis.

Many of SKH’s findings are plausible and unremarkable. It would be surprising if the divergence between converting and continuing societies had not begun before demutualization as it would have been reckless for those societies likely to convert to have done nothing to prepare for the ‘new world’ in which they would find themselves. Similarly, continuing societies should surely have been less profitable than converting - they were driven by different motives.

The wave of demutualizations on which SKH focus was a step-change and removed most of the largest societies from the sector. With hindsight, it is clear that these conversions shifted into the listed bank sector a number of institutions which were neither ‘fish nor foul’ - large societies which appeared to have the management ambition, scale and business skills to survive as listed banks, but in reality lacked some or all of these. The message for the future, as the financial crisis has reinforced, is that the focus should be on better management in all financial institutions of whatever organizational form.

It will be interesting to see what role apparently unexciting mutual institutions such as building societies will have in the slow resolution of the financial crisis. The largest remaining building societies appear committed to mutuality, but mutuals may become footnotes in financial history unless it is possible to establish new mutuals of significant size, or a mutual route is found to unwind the state ownership of large banks, or other existing institutions choose to adopt mutual form.
References


Table 1

Britain’s demutualized building societies which became listed banks

<table>
<thead>
<tr>
<th>society</th>
<th>year of demutualization</th>
<th>subsequent fate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abbey National</td>
<td>1989</td>
<td>taken over by Banco Santander, 12 November 2004</td>
</tr>
<tr>
<td>Alliance and Leicester</td>
<td>1997</td>
<td>taken over by Banco Santander, 10 October 2008</td>
</tr>
<tr>
<td>Halifax</td>
<td>1997</td>
<td>merged with Bank of Scotland to form HBOS, 10 September 2001, then merged with Lloyds TSB plc, 19 January 2009, to form Lloyds Banking Group</td>
</tr>
<tr>
<td>Northern Rock</td>
<td>1997</td>
<td>nationalized, 17 February 2008</td>
</tr>
<tr>
<td>Woolwich</td>
<td>1997</td>
<td>taken over by Barclays plc, October 2000</td>
</tr>
</tbody>
</table>

Note: SKH’s analysis excludes Abbey National and Bradford and Bingley as their demutualizations did not take place in 1997.