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Risk in Recovery: Views of Non-Executive Directors of UK Building Societies

University of Huddersfield
FEGReG
Financial Ethics and Governance Research Group

Risk in Recovery: Views of Non Executive Directors of UK Building Societies

A research report from the Financial Ethics and Governance Research Group, University of Huddersfield

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Building Societies Association

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Preface and Acknowledgements

This research report originated from general discussions regarding the difficult and challenging role of Non-Executive Directors within and following on from the recent financial crisis. Parallel discussions centred on the various mutual sectors and the challenges, and opportunities that various mutual organisations might face as a 'new dawn' begins to arise within the financial services industry. Building Societies represent a very significant and long-standing mutual 'force', and the irony of seeing at the centre of the UK's financial woes the demise of former Building Societies all made for a further research interest.

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Introduction

Just over three years ago the UK financial sector witnessed the rapid deterioration and failure of the Northern Rock Bank. Customers – savers – formed long queues outside the provincial and suburban offices of this former regional building society, de-mutualised in 1997 under the 1986 Building Society Act powers, serving to emphasise and visually illustrate the most significant and substantial run on a UK Bank for over 150 years. A little over two years ago Lehman Brothers filed for US Chapter 11 bankruptcy – with total pre-bankruptcy assets valued at almost $640 billion making it the largest bankruptcy in US financial history dwarfing the earlier touchstone of Corporate Governance failure, that of the Enron Corporation.

Expressions of shock and disbelief littered the financial and business press – the Director-General of the Building Societies Association (BSA) noting at the time the episode had *'been utterly, unbelievably, astonishing'*[1]. For this particular sector, the Building Society 'mutual' sector, the backdrop of the previously noted 1986 Building Societies Act is significant: this recent period has seen the last remaining truly independent flag-bearer of the 1986 de-mutualisation process fail.

The UK Government's reaction has been to focus on the nature of the banking collapse, with the House of Commons Treasury Select Committee into the Banking Crisis[2] identifying 2 key themes in relation to risk:

- That risk and complexity within the banking sector had increased dramatically over the previous twenty years with a widespread, but often misguided belief that risk was being dispersed and 'managed';
- There had been a financial sector demonstrating significantly increased leverage, with those demonstrating the greatest appetite for rapid growth through leverage being amongst the heaviest casualties

Two key reports have served to focus both the concerns and the future expectations of the broader financial service sector:

a) The Financial Services Authority (FSA), through the Turner Report[3], considered how to frame a regulatory response to the global banking crisis focusing on, amongst other areas, a new approach to regulation: designed to be *'more intrusive and more systemic'*. Importantly in relation to the focus of this work, the Turner Review has also suggested a seismic shift in the governing role of non-executives, supporting greater challenge from a more professionalised body of Non Executive Directors (NEDs).

b) Then the Government appointed Walker Review of Corporate Governance of UK Banking Industry[4] set out to consider and review *'corporate governance in UK banks in the light of the experience of critical loss and failure throughout the banking system'* (Preface). At the centre of its examination were a number of risk specific concerns:

    - Effectiveness of risk management at board level, including the incentives in remuneration policy to manage risk effectively
    - The effectiveness of board practices and the performance of audit, risk, remuneration and nomination committees

The overall concern here has been that at the centre of the banking crisis was a mis-management of risk; and at the centre of the management of risk is the board, and more particularly the NED.

[1] BBC website article date September 29 2008 http://news.bbc.co.uk/1/hi/business/7641925.stm [accessed June 5 2010]
[2] House of Commons Treasury Committee Banking Crisis: Regulation and Supervision Fourteenth Report of Session 2008-09 July 21st 2009
[3] Turner Report (2009) A Regulatory Response to the Global Banking Crisis Financial Services Authority. Note also on June 16, 2010, the Chancellor of the Exchequer, George Osborne, announced plans to abolish the FSA and separate its responsibilities between a number of new agencies and the Bank of England
[4] Walker Review (2009) A Review of Corporate Governance in UK Banks and Other Financial Industry Entities HM Treasury

Against the wider concerns of the financial services sector, and the varied demise and disappearance of the ten[5] former independent and de-mutualised building societies, a number of commentators found renewed interest in the building society mutual model. For example, the formerly referred select committee considered building societies to have generally *'operated a safer business model'[6].* The Building Societies Association sought to emphasise this relatively sound track record in its submission to the Walker Review in stating that what is recognised *'are the shortcomings that have been evident in the quality of decision-making of board banks'* yet '*building societies themselves have a good, and improving record on corporate governance'[7]*.

Whilst there have been exceptions, such as with the failings and part-failings of the Dunfermline and West Bromwich societies, building societies have generally been seen to manage their risks in a more cautious and balanced manner, reflecting their differing financial construction and legal framework but also their community (mutual) stakeholder concerns. The Oxford Centre for Mutual and Employee-Owned Business identify three main reasons for this:

1. Firstly, regulation limited the extent to which building societies could diversify into the areas (e.g. derivatives trading) that proved to be a serious problem for many banks.
2. Secondly, their mutual status meant that they generally had a lower risk appetite irrespective of regulation.
3. Thirdly, both by regulation and choice, building societies limited their dependence on wholesale funding markets and securitisation.[8]

The central issues at the crux of this research project then are:

- the interest in trying to establish how building society boards are currently viewing risk;
- how the recent financial crisis has affected their risk perception, risk appetite and risk management;
- both taken from the perspective of NEDs, who are increasingly seen to have a change of focus of their role and perhaps some significant changing expectations of their influence in controlling and directing financial institutions - in this case, building societies.

A view may be that a more conservative risk policy will bear dividends in increased consumer confidence and wider government and regulatory satisfaction of the mutual business model, but an alternative perspective is that the risk pendulum may swing too far towards risk certainty and risk avoidance, with a loss of competitive edge as the recession recedes. Finally there is a question about how NEDs themselves view the recent proposals for a more emphasised role in the Corporate Governance of building societies.

2. History and Profile of the UK Building Society Sector

Building societies originally grew out of the friendly society movement of the late 18th century. Their development was very much linked to industrialisation and the need for housing for workers. Underpinned by a self-help ethos, the first examples[9] were 'terminating' societies: members would agree to pay into the society, build houses together from the collected funds (allocating the first homes via lottery) until every member was housed at which point any surplus funds were distributed to the membership and the society terminated.

The first 'permanent' society was formed in 1845 (The Metropolitan Equitable) and by 1890 there were 2,579 societies[10] in existence, with virtually every town and industrial centre having its own society, as

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5 See Appendix 1
6 House of Commons Treasury Committee Banking Crisis: Regulation and Supervision Fourteenth Report of Session 2008-09 July 21st 2009
7 BSA response to the Walker Review, June 2009
8 Oxford Centre for Mutual and Employee-Owned Business (2009) Converting failed financial institutions into mutual organisations BSA
9 The first recorded society was established in 1775 - Ketley's Building Society of Birmingham
10 Short J (1982) Housing in Britain pp121 -131

well as there being many work-based societies. During this early period societies generally remained very small but continuing rationalisation through mergers reduced the numbers to 481 in 1970 and 130 by 1988[11]. Their greatest period of growth was between 1955 and 1980 as mass owner-occupation took hold in UK society and in national housing policy, with building societies benefitting from an effective retail deposits oligopoly alongside UK banks.

In line with wider de-regulation and privatisation of both public and regulated sectors, the 1986 Building Societies Act substantially widened the powers of societies in the field of housing and personal banking services. This also paved the way for the first 'de-mutualisation' of a building society: in 1989 Abbey National resolved to convert to plc, and bank status, and in July 1989 the Abbey National Bank PLC was formed. The de-mutualisation process was most significantly implemented within larger societies such that by 1994, two-thirds of the total assets held within the building society sector until then had transferred out of the sector[12]. Having accounted for 80% of all residential loans in 1994, this figure fell rapidly to 25% by 1999. Now the building society sector holds just over 20% of UK retail deposits and has a little over 20% of the UK mortgage market.[13]

The *potential* advantage for a mutual is easy to see. It has been recognised for some time that investor-owned companies carry and indeed target a higher total risk than mutuals, with investor owned companies accepting riskier lines of business and working in geographical areas of high risk[14]. In any case, despite various relaxations in legislation and regulation, most notably the 1986 legislation, building societies are in effect 'creatures of statute', being only able to do those things they are allowed to do and only operating within the parameters established by parliament. Building societies are therefore subject to a number of statutory limits[15] which restrict the flexibility of their business model relative to banks.[16] According to the FSA, these limitations are necessary to prevent societies from undertaking too much business in areas that are considered to be unduly risky.

> *'One of our supervisory aims is to reduce the risk of building societies failing or needing to enter rescue mergers, by improving the match between societies' risk management processes and the risks associated with their chosen business models.'*[17]

Aside from the immediate and direct service provision available through building societies, a wider and very current consideration at Government level is the preservation and indeed encouragement of diversity in the financial services sector. As indicated earlier, there has been a continuing rationalisation within the building society sector for more than 150 years as well as the de-mutualisation losses from the sector so that there are now just 49[18] independent building societies operating in the UK. The rationalisation process is not easy to reverse, with the Ecology Building Society being the only newly created society in recent years (established in 1981).

The importance of diversity within the wider financial market has been recognised by many and the argument has been made for some time[19] that a greater variety of financial institutions provides for increased stability in contrast to a much narrower concentration of such institutions. There is in any case a benefit derived from the consumer sovereignty and consumer choice in a competitive but diverse market. On this point, the government's stated intention is to reinvigorate competition in the banking sector include *'supporting competition and choice through diversity, most importantly through maintaining a strong mutually-owned financial sector*[20]*.* This may receive some impetus from the newly

[11] Wells G E (1989) *The revolution in Building Societies* Long Range Planning 22 (5) pp 30-37
[12] Cook J et al (2001) Mutuality and Corporate Governance: the Evolution of UK Building Societies Following De-Regulation ESRC Centre for Business Research, University of Cambridge Working Paper No. 205
[13] FSA CP 2009/17 Sourcebook
[14] Lamm-Tenant J and Starks L T (1993) 'Stock versus mutual ownership structures: the risk implications' Journal of Business Vol 66 (1) pp 29-46
[15] The Building Societies Act 1986 requires at least 75% of society lending to be for mortgages secured on residential property, retail deposits to account for at least 50% of total funding and limits the use of derivatives.
[16] This again reflects the 'more cautious and balanced' approach to risk identified earlier from the work by the Oxford Centre for Mutual and Employee-Owned Business.
[17] FSA Sourcebook (2009) p.27
[18] Soon to be 48 with the technical re-constitution of Kent Reliance as an Industrial and Provident Society – see Appendix 2
[19] Llewellyn, D. T. & Holmes, M. J. (1991) 'In Defence of Mutuality: A Redress to an emerging conventional Wisdom' Annals of Public and Co-operative Economics, pp 319-354
[20] HM Treasury White Paper, *Reforming Financial Markets*, July 2009.

announced Independent Commission on Banking to be chaired by Sir John Vickers. Mr Osborne, in introducing the proposals for this commission expressed some further support for the Building Society/mutual sector(s)[21]:

> *"building societies and mutuals have an important role to play in the future. We want to strengthen them and support those who want to create mutuals."*

Yet without significant Government support, regulatory requirements for a healthy balance sheet and operational track record *'make it virtually impossible to create a new society from scratch'*[22].
The potential to do so from the re-constitution of the now state-owned Northern Rock does now present itself and this is the focus of the earlier report by the Oxford Centre for Mutual and Employee-Owned Business[23]. But one commentator has provided a cautionary note that *'of course, any new mutual society will continue to face competitive pressures to act commercially'*[24].

This historical perspective is provided to put the more recent events into some longer-term context, not least because the recent banking crisis, and the challenges that this brings for the building society sector, should not obscure some of the longer-term changes in the financial sector that have affected building societies. Without some significant shift in the policy arena the external pressures and dynamics that produced these original changes will presumably quickly re-surface and impact once again. These issues are returned to again in the final section.

3. The Non Executive Director

A Non-Executive Director (NED) is someone who has no significant interests or management responsibilities to a company or organisation other than that of being a director. A NED plays a key part in corporate governance and in the functioning and ethos of the unitary board. Their role has been endorsed and clarified in a series of corporate governance reviews and in a variety of sector specific policy guidelines and regulatory requirements.

The Cadbury Report[25] considered that NED's should:

> *'bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct … [and] the calibre and number of non-executive directors on a board should be such that their views will carry significant weight in the board's decisions.'*

The Higgs Report[26] provided the most comprehensive review and advice on the role and responsibilities of the NED noting that as members of the unitary board, all directors are required to:

- provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enable risk to be assessed and managed;
- set the company's strategic aims and review management performance;
- set the company's values and standards

In addition to these requirements for all directors, the role of the non executive director has the following key elements:

- **Strategy:** NEDs should constructively challenge and contribute to the development of strategy.

[21] House of Commons Debate – Financial Services Regulation – June 16 2010
[22] Leadbetter C and Christie (1999) To Our Mutual Advantage Demos
[23] eg Oxford Centre for Mutual and Employee-Owned Business (2009) Converting failed financial institutions into mutual organisations BSA
[24] Branston, R. et al. (2009) "Strategic Failure" and the case of the UK's former building societies: Lessons for the reform of governance in the UK Banking Sector University of Bath: School of Management Working Paper p.102
[25] Cadbury Report (1992) The Committee on the Financial Aspects of Corporate Governance
[26] Higgs Report (2003) Review of The Role and Effectiveness of Non-Executive Directors Department of Trade and Industry

- **Performance:** NEDs should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.
- **Risk:** NEDs should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible.
- **People:** notably remuneration of executive directors and in appointing, and where necessary removing, senior management and in succession planning.

As part of the research team providing information and advice to the Higgs Review, McNulty T, et al[27] identified the need for NEDS to consider both their strategic and control roles and the (potential) tensions and conflicts that may arise between these. More specifically they considered three behavioural dynamics expected from NEDs:

- They should be engaged and non-executive;
- They should challenge and support;
- They should demonstrate independence and involvement.

The Walker Review further focussed, amongst other issues, on the role of the NED with the expectation of evolution and development of current 'best practice' rather than radical change. It included a number of specific recommendations on the position of the NED in terms of their training and support and with regard to their need to provide challenge and control. This is considered further later in section 4 of this report.

Earlier Governance reports, including the Cadbury Report and Higgs Review, have subsequently been incorporated within the more comprehensive and overarching guidance of the updated UK Corporate Governance Code [28]. This forms the principle and fundamental source of advice on governance within both the UK Corporate world, but also as a baseline reference for guidance within a range of sectors and business areas

Notwithstanding all of the above, the NED is in strictest terms, no different from an executive board member in holding the same fiduciary and governing responsibilities within a unitary board. But the reality of what an NED does and their role and remit, and the context in which NEDs 'operate' can be somewhat different.

Empirical research by Hobeche and Garrow for the Roffey Institute[29] concluded that:

1. **Effective governance may be at risk**, as a result of:
    a. Boards being 'risk-averse'
    b. Board evaluation being of a 'tick-box' approach
2. **NED roles are still unclear**, noting
    a. NED roles are increasingly onerous
    b. NED work requires 'soft skills' more than the previous Board or top management experience may alone imply
3. **There is a shrinking talent pool of NEDs**, as
    a. The pool is drying-up
    b. Board diversity remains limited
4. **There is little help provided to new NEDs**, in relation to induction and training

Their report concluded that, post-Higgs and other reports, *'board practices may be changing less quickly than recommended by Higgs et al'* and by inference the role of NED is both a challenging and challenged role in which individuals must apply themselves.

[27] McNulty, T., Roberts, J. and Stiles, P. (2002) Creating accountability within the board: the work of the effective non-executive director: A Report for the Review of the Role and Effectiveness of the Non-Executive Director. London: Department of Trade and Industry.
[28] i.e. the former Combined Code of Corporate Governance – originally published by the London Stock Exchange in 1998 with subsequent updates produced by the Financial Reporting (FRC) with the most recent update published in May 2010.
[29] Holbeche L and Garrow V (2005) The Rise of the Non-Executive Director Roffey-Park

4. Key Findings from the Turner Report and Walker Review

Turner Report (2009)

The Turner Review was undertaken by the Chair of the Financial Services Authority (FSA) at the behest of the Chancellor of the Exchequer in order to review and make recommendations for reforming UK and international approaches to the way banks are regulated. It identified three underlying causes of the crisis: macro-economic imbalances, faulty and misapplied financial innovation, and key deficiencies in bank capital and liquidity regulations. These were further underpinned by an exaggerated faith in the concept of self-correcting markets.

The Turner Review, reporting in March 2009, concluded that there needed to be a renewed concern for:

- Fundamental changes in capital, liquidity and published accounts
- Institutional and geographic coverage: economic substance not legal form
- Other important changes: credit ratings, remuneration and counterparty risks
- Macro-prudential analysis and the need for intellectual challenge
- A new FSA approach to supervision: more intrusive and more systemic
- Governance and risk management: firm responsibilities and structures
- "Narrow banking" versus "investment banking": major constraints but not complete separation?
- Cross-border banks: more international cooperation and more national powers

Ironically the FSA was also seen by the new incoming UK Government as part of the problem in itself and as a key element of the 'tripartite agreement' between the FSA, the Treasury and the central Bank of England which were considered to have 'utterly failed' both before and after the crisis according to the new Chancellor of the Exchequer, Mr. George Osborne: *'The FSA became a narrow regulator, almost entirely focused on rules-based regulation.'*[30] In place of the former tripartite arrangement, the Government is to have a new Financial Policy Committee within the Bank of England, a Prudential Regulation Authority operating under the Bank of England, alongside a consumer focussed, but yet to be formally constituted, Consumer Protection and Markets Authority.

Walker Review (2009)

The Walker Review was published in November 2009 and provided 39 recommendations[31] for change based on five broad areas:

- **Board size, composition and qualification** – reference to board balance, knowledge and understanding; time commitment and dedicated support;
- **Functioning of the board and evaluation of performance** – emphasising the role of NEDs in challenge, with increased expectations for the role of chairman and senior independent director (SID) and more generally in financial and board leadership experience; enhanced expectations in terms board appraisal and performance review;
- **The role of institutional shareholders: communication and engagement** - whilst less relevant to the building society sector, highlights further best practice from the revised Combined Code;
- **Governance of risk** – the establishment of a Board Risk Committee supported by high-level direct reporting from a Chief Risk Officer (CRO), as well as other independent advice as necessary;
- **Remuneration** – various detailed notes of recommendation on the review, form and performance expectations attached to remuneration packages especially that directed at "high end" employees

[30] Mansion House speech June 2010

[31] The review was aimed principally at larger banks and financial institutions – Walker acknowledged that a calibrated approach was needed for smaller institutions and those with less complex business models.

These reports, their recommendations and general expectations, then became a central focus of the 'field' research, as below.

5. Research Plan and Methodology

Focus and overall structure
The focus of the research and the approach and scoping of the research methodology essentially took place in two parts:

Phase 1:
Initial outline questionnaires distributed to 52 building societies (reducing to 49 with subsequent mergers) requesting information from Company Secretaries and more specifically directed towards the Chair of Audit and one other NED. This was distributed via e-mail with support from the BSA in promoting responses and engagement.

Questions were classified under four sections and focused on:

Section One: Changes in the Competitive & Regulatory Environment

a) Views on the Walker Review
b) The overall competitive environment for Building Societies

Section Two: Your Building Society and responses to change

a) Perceptions of the Boards overall view of risk
b) The embedding of risk management
c) Changes in the governance structure and remuneration policy

Section Three: Your role as an NED

a) The general role and perception of the Board
b) Training and preparedness for the role of NED
c) Current confidence as NED

And given the specific focus and form of financial service as defined by the 'mutual' label, Section Four was a single question seeking views and opinions on the 'dividend of mutuality' for the building society sector and the specific building society in question.

Two societies did not return questionnaires but indicated a willingness to engage at Phase 2. The response rate for phase one was:

- Substantial return (ie at least 1 NED fully completed questionnaire) = 13 societies (27%)
- Others confirming willingness to participate in stage 2 = 2 Societies (4%)
- Confirmed to be not participating = 4 Societies

The response rate, at a combined total of 31% was therefore slightly lower than that expected of around 35-40%. Significantly, but perhaps as might be expected, it is the smaller Societies (ie those with assets of less than c. £350m) that have been less inclined to respond.

Phase 2:
This was based on a series of one-to-one interviews of NEDs to provide a further informed perspective on key issues and concerns. Our initial target sample here was between 16 and 20 in total, stratified according to Peer Group classifications. Our completed profile was slightly short of this with the completed interviews profiled as:

- Peer Group 1: Asset size over £1bn – 5 completed
- Peer Group 2: Asset size of between £400m and £1bn – 5 completed
- Peer Group 3: Asset size of less than £400m – 4 completed

The range of Society types, location and range of products is, in our view, a reasonable reflection of the full range of Societies although we consider some further benefit may have derived from a further niche market Society representation (geographically or by focus).

6. Research Responses And Commentary

The summary responses here are provided in respect of each question taken from the original questionnaire, which then became the focus of more detailed discussions within the interview stage. With each question was provided a short preamble to help indicate the main areas of concern and, in part at least, the rationale for the inclusion of the question. The preamble is shown under each question in italics.

Section One: Changes in the Competitive & Regulatory Environment

Q1 Views on the Walker Review

The Walker Report provided a wide-ranging review of the Corporate Governance of UK Banking Industry. The findings and the implications are still being digested in many institutions and organisations. Here we are interested in receiving NEDs overall assessment of the value of the report to the wider Building Society sector and the reasons why they are of this view.

The responses in the initial questionnaire were predominantly favourable towards the Walker Review, with 20 of the 24 responses confirming a positive view of the value of the Report. One respondee indicated very favourable support and 3 holding a negative view.

Comments favourably supporting Walker included:

> *'The Review encourages further challenge by NEDs but also emphasises the need for more training and support from within the organisation'*
>
> *'Requirements for and role of Board Risk Committee'*
>
> *'Emphasises longer term rewards and claw-back provisions'*
>
> *'it should encourage more detailed scrutiny of risks'*
>
> *'it indicates and reinforces the time commitment necessary in the NED role'*
>
> *'At least the Review is sensible and balanced!'*

Areas of concern noted included:

> *'Enhanced corporate governance can help in raising standards of decision-making and risk management but is no panacea and has to be seen in the context of a wider approach that includes effective supervision … of those pursuing riskier business models and those of sufficient size to be of systemic importance'*
>
> *'Too strong an adherence to every aspect will create either too large a board or, a board of 55-65 year old males with banking/financial services experience alone'*

'There is a danger that, if handled in the wrong way, the relationship of ED and NED becomes confrontational and moves away from being a unitary board'

'It may be interpreted by some in too prescriptive a way – too much "one size fits all" – with a tick box interpretation of what makes a good board'

'The danger is that Boards go for 'safe' options in appointing NEDs: high profile 'names', ex-CEOs of large Corporations, who might well be part of the problem'

Perhaps the most strongly worded and unfavourable response was that, for the smaller financial institution, the Review suggests:

'It's overkill, and in danger of throwing the babies out with the bathwater!'

Q2 The overall competitive environment for Building Societies

Through the financial crisis there has been some evidence of renewed interest and support for the Mutual model, but there has at the same time been the high-profile failure of the Dunfermline Building Society and problems experienced at the West Bromwich Building Society. The competitive landscape is still in some flux and over the short-term it might be expected that there will be a period of reflection and a focus on stabilisation for many across the wider financial services sector. Here we are interested in NED views over the short to medium term – say the next 12 to 18 months – and the balance of threats and opportunities facing the Building Society sector.

The responses in the initial questionnaire were predominantly pessimistic, as perhaps might be expected in the current/recent climate. So 17 of the 24 responses identified more threats than opportunities in the business environment. Then 5 respondents identified significantly more threats than opportunities and just one seeing predominantly more opportunities. One respondee failed to provide a clear answer.

Some of the challenges identified included:

'Interest rates are so low it's almost impossible to trade profitably'

'Margins being squeezed and there's an unlevel playing field, especially with Government backed financial institutions.'

'The new capital requirements and liquidity management regimes are draconian for the smaller society.'

'(Some) reputational issues for the sector [ref: to Dunfermline] and perhaps FSA sees sector as part of the problem not part of the solution?'

'Payments to FSCS!!'

'Core markets are fractured: savings and mortgage markets both down.'

'Public sector retreat/cut-backs.'

'Major focus on PLC financial interests, including Governments.'
'Excess and at times inappropriate regulation. Also availability of suitable NEDs to match regulatory expectations.'

'Regulatory 'pendulum' has swung too far.'

'Very tight managerial/administrative costs against market % levels.'

'The Building Society model is under severe stress … we're really just treading water until interest rates rise.'

'If Nationwide ever went to a bank, other large ones would be likely to follow and the sector could all but disappear.'

'The FSA Sourcebook is an attack on mutuals – the FSA have an agenda and its to reduce the number of mutuals.'

'View going around that Regulator wants 'Snow White and the Seven Dwarfs' [ie Nationwide plus seven large regionals].'

Views on the potential opportunities included:

'Focus on mortgages as a core product – "stick to the knitting", emphasising community benefits alongside housing needs/requirements'

'We are a niche player with an attractive brand that has customer trust and confidence – far more so than the banks.'

'Good customer service and branch network – public need for local identity and allegiance.'

'Trust in the sector and in the individual brands.'

'Varied routes to market using modern technology reaching out to willing customers.'

'Aggressive marketing of mutual concept and mutual model – establish benefit of diverse service provision for customer choice.'

'Further rationalisation … Inevitably further mergers in the sector leading to fewer, but stronger, societies going forward.'

'Great potential in sharing costs, perhaps even cross-mutuals, if we can only make it happen!'

Section One Overview

In summary what was identified as key issues with regard to the Walker Review were:

a) The need for proportionality in applying the key elements of the Walker Review. It is felt that the main target of the Review is the larger financial institution and some recommendations may incur disproportionate management costs for smaller Building Societies;
b) The intensified emphasis on NEDs coming from financial backgrounds, indeed having detailed financial services experience, would be detrimental to the retail business focus and mutual ethos of the sector. NEDs felt that a continuing need for board diversity was important and evident in discussions;
c) The key remains the human element, both for the individual appointee in how they go about their activities as an NED, and how the Board act and undertake their tasks as a collective. In the end, how to challenge in a positive and effective way cannot be prescribed.

Looking at the competitive environment:

d) The current status is pre-dominantly one of *'weathering the storm'*.
e) A continuing challenge for NEDs is in promoting entrepreneurial activity and encouraging the pursuit of (appropriate) opportunities.

<u>**Section Two: Your Building Society and responses to change**</u>

<u>Q3 Perceptions of the Boards overall view of risk</u>

A key focus and concern for all of the recent reports, reviews and discussion has been the prevailing risk culture of the financial services industry. It is true that this is easier to discuss than determine, but risk culture is concerned not just with what happens but how risk is perceived and considered: the acknowledgement and promotion of constructive questioning and challenge throughout the organisation but especially at Board level. We are interested here in NED views about their current risk culture – most specifically the risk appetite and risk taking behaviour - and any perceived changes in response to various reports (e.g. the Walker report).

The focus was on identifying if there was a concern about being more or less risk averse. 4 answers indicated a concern about being less risk averse and 1 significantly concerned. 9 were concerned about being more risk averse and 1 significantly so, with 5 a balanced view. Clearly the level of concern expressed is itself determined by where a NED believes their society currently sits and in which direction risk may shift. This question produced a variety of additional comments and we present here more individual quotations for illustration:

> *'Yes, there has been a shift in risk appetite – and for the better. My concern as a NED would be us becoming less risk averse as we come out of the recession and "being tempted" to take greater risks.'*
>
> *'I worry that excessive concentration on obvious existing risks will reduce the chance of identifying the next big challenge to come along OR reduce the chances of us taking up profitable opportunities.'*
>
> *'The need to understand and handle the Capital Requirements Directives (CRD) meant the game changed for NEDs – we needed to gear up to a more sophisticated approach.'*
>
> *'We've always been risk averse, but gradually less so. I'd say we're simply more risk aware and know that we'll need to take more risk in some areas, but hopefully in a carefully managed way.'*
>
> *'Over the year we've sought to maintain and attract high quality mortgage business – modest Loan to Value (LTV) rates, affordability criteria, specialist underwriting on a case-by-case basis – we're determined not to compromise our quality criteria.'*
>
> *'Our BS has consistently operated a risk averse model and moved very cautiously up the risk curve BUT we can see that the current culture (eg reflecting Walker etc) might make this too extreme and restrict opportunities.'*
>
> *'XY has always adopted a risk averse attitude … recently we've tightened our lending criteria but have raised our average LTV a little given lower house prices.'*
>
> *'We hope to keep within our current risk profile but some relaxation may be necessary, but this would be limited and gradual.'*
>
> *'On balance I guess we're more risk averse but that's appropriate and not a point of concern: we've tightened our underwriting criteria and substantially withdrawn from commercial lending (but will re-engage when appropriate).'*
>
> *'Traditionally we've been at the lower end of risk and don't want to be even more risk averse than we already are – business is about taking risks and profits are the only way open to us to replenish capital.'*

'Secured business lending and buy-to-let virtually frozen BUT in our heartland, through local branches (where we know the property market well), we've increased some LTV to first time buyers.'

'The Board has generally taken a prudent stance on risk. Our risk appetite hasn't changed but there's a heightened awareness of the need to manage different risks and their (potential) consequences.'

'NEDs are demanding more detail, more reassurance, but we might drown the strategic issues in the detail if we are not careful.'

'We've gone back to basics and are focussed entirely on prime residential lending for new business.'

'We're getting better at assessing and managing risk – better at appropriate pricing for a given risk.'

'We don't have an ego … we're not seeking to be the biggest or a 'name', we just want to do good business that suits our needs. If we're careful with our lending assessment, based on good knowledge, we can move further.'

'We've been too conservative in the past and couldn't survive so we've had to address some risk issues (pre-Walker) and our risk-taking behaviour is now gathering pace, becoming a nimbler business.'

'It (risk) has absorbed much Board attention. We've had to do rapid catch on risk assessment techniques. We are more risk averse but do now review our risk appetite more often.'

'We were risk averse and are more so now. ED's are swamped by stress testing which is often disproportionate to the benefits it gives.'

'We need the reintroduction of a Glass-Steagal[32] type separation of all different financial institutions and associated risk'

Q4 The embedding of risk management

The board is dependent on the quality of information it receives: 'quality' including issues such as relevance, timeliness, focus and scope, and overall critical incisiveness. In a recent report on the wider financial services sector Deloittes noted that 'the lack of effective challenge arose from defective information flows, inadequate risk analysis and interpretation'. Management reports provide the means for board member to apply and demonstrate their application of critical challenge and facilitate (or hinder) high-quality decision-making by boards. Internal reporting is also a primary activity determining the ultimate quality of external reporting. Here we are interested in NED views on the quality of internal reporting in support of the NED role and whether the importance of Board reporting is embedded in the organisation.

Responses to the questionnaire tended to produce a profile of satisfaction with the internal reporting processes: just one NED noted some noticeable inconsistencies, making internal challenge more difficult. Another provided an inconclusive response. Of the remaining 22 responses, 10 noted effective internal reporting and 12 very effective reporting. It is acknowledged that this is in itself inconclusive, but still interesting in that it may yet indicate either safe, secure and effective internal reporting and Board scrutiny, or a continuing difficulty for NEDs in assessing if they are indeed aware of, and receive reports on all the relevant critical issues. The detailed commentary in the questionnaire and in interviews did however provide further insight:

'There were some inconsistencies but much resolved now, and the setting up of an ALCO to support the Board was a good step forward.'

[32] Glass-Steagal Act 1932 (US)

'The Executive Risk Committee now report though Audit, so there's greater comfort and challenge.'

'We've monthly reporting of KPI's with exceptions and action plans.'

'There's a very open management culture with a commitment to improvement: we can see that internal management information needs further work and that's happening.'

'We are reliant on key people for MI with no rotation of people as we're quite small.'

'Stress testing and scenario planning greatly improved with more active and engaged debate around these.'

'Focused reports with extensive KPI review – reporting generally overhauled in 2008 with Board Risk Committee and other changes improving quality and depth of information flow.'

'Credit risk reporting very well established – funding, liquidity and profitability reporting only just catching up "post-crisis".'

'Committee packs better organised and structured and ALCO improving with "maturity ladder". Still can be a challenge "seeing the wood for the trees" in detailed reporting.'

'Some management information reports are still problematic but the new Audit Manager led to step-change in reporting and discussion at Audit Committee.'

'Improved Internal Audit (IA) reports and shared use of IA with another mutual has provided cross-learning. But we've also learned some absence of problems is due to good management of process by individual staff rather than comprehensive procedures etc. which needs addressing.'

'The Internal Capital Adequacy Assessment Process (ICAAP) and 'Treating Customers Fairly' approach are much improved – better overview of all business rather than separate business streams. Reflects more focussed management/organisational structure.'

'The problem is that most organisations get into difficulty because "risk is too difficult to call".'

Q5 Changes in the governance structure and remuneration policy

The Turner Review questioned whether changes in governance structures are required to increase the independence of risk management functions. The Walker Review itself recommends further consideration of governing roles and responsibilities including the formation of a Board Risk Committee (BRC) and an enhanced status for the Chief Risk Officer (CRO) – both being seen as 'structural enablers' of effective risk management[33]. Here we are interested in their society's responses to these recommendations and their views on the relative importance and support for structural change. Given the public and political focus on executive remuneration across financial services sector, we also asked a specific question regarding the interaction of the remuneration committee with other committees.

From both the Company Secretary and the NED Questionnaires, the following changes were noted within the research sample:

[33] FSA CP 2010/3: Effective Corporate Governance. Essentially stated that each building society needs to consider its own risk controls – and whether they need a Board Risk Committee and a senior Risk Officer

Relevant Change	Introduced	Comment
Senior Independent Director	1	
Chief Risk Officer	4	1 - now reporting to Board direct 1 – currently reviewing with intention to implement 1 – indicated incorporated with FD role
Board Risk Committee (BRC)	5	3 – no requirement for BRC at this time 3 – included as Audit & Risk 1 – currently reviewing proposals for change
Remuneration Policy and/or Structure	3	2 – currently reviewing proposals for change

'We're too small to warrant a separate CRO.'

'The scope to have a dedicated CRO is limited.'

'We don't think we need a separate BRC, the task is incorporated very efficiently in our Audit & Risk Committee'

'The society is not involved in non-standard products and bonus levels are both generally limited and focussed on risk management rather than financial performance per se.'

'Bonus deferral is already under discussion, but to note that recent governance proposals assume that variable pay (ie bonus) can be made as 'non-cash' and/or easily deferred – this is more difficult where equity (shares) is not available and the current climate demands short-term survival as much as consideration of long-term risks.'

'Some changes in remuneration but tinkering rather than anything wholesale – not seen as a major issue with some longevity amongst senior Exec. They've been in for the long haul!'

'If we had a more complex business model I could perhaps see the point of a BRC – but we don't.'

'In a small organisation people need to wear more than one hat, so a separate CRO is pretty unlikely.'

'More significant issue is: "does Risk get sufficient space at the Board – that's the challenge.'

'We have a simple business model – CRO not necessary and simply unaffordable for many Building Societies.'

Section Two Overview

In summary what was identified as key issues with regard to current risk appetite and risk management were:

a) For some the crisis had produced a re-assertion, a re-affirmation, of traditional prudent approaches – often described in terms of a focus on (traditional) residential lending within modest and quite prescribed lending policies (e.g. in terms of Loan to Value (LTV).
b) For others there was a reflection on how best to manage or balance the risk appetite as the recession recedes – how, and to what extent, the risk approach may return to equilibrium (i.e. business as usual).
c) A concern for some was the recognition that their business was already relatively risk-averse. The question then was how to identify and develop opportunities that both reflect core values, but support positive business development that suits the customer base and membership.
d) Most identified a more developed and focused risk awareness and structured risk-assessment (often evidenced in references to a wider application of various risk-assessment techniques).
e) Most identified a strengthening of the risk management process, the embedding of risk, further into the organisation, often noting that the simpler business and organisational structure made risk, and risk decision-making, more transparent.
f) Overall there was some feeling of enhanced confidence, having worked through the peak of the crisis without significant damage, and having seen some relative endorsement of 'their approach'.

In terms of governance structures and remuneration issues:

a) The general response was that some minor fine-tuning had been taking place, but some of the core recommendations (of a Board Risk Committee and a Chief Risk Officer) were not to be voluntarily adopted as a matter of course. This is in line with Walker and Turner reviews both of which acknowledge that BRCs and CROs are not necessary elements within smaller, less complex financial institutions
b) Most NEDs saw the issue of both the scale and form of executive remuneration as of less relevance and concern to the sector – executive directors cannot benefit from company shares as such and the focus is really on stakeholders perceived fairness e.g. comparisons to general staff remuneration and annual 'settlements'.

Section Three: Your role as an NED

Q6 The general role and perception of the NED

Advice on Board Governance has consistently emphasised the need for effective independent critical review and oversight, and the role of the NED should be central to this process. This has again been noted in the Walker Review with a number of proposals and recommendations to support this. In practice Board Governance can be undermined and the NED role diminished by a strong executive team. The Institute for Chartered Secretaries and Administrators (ICSA) for instance, in responding to the Walker consultation, questioned whether steps were needed to encourage boards to understand that they are 'one step down' from the owners rather than 'one step up' from the executive management. Here we are interested in NED views on their current role and their perception of others about their role.

There was a very clear feeling amongst NED respondents that their position was both emphasised and supported within the Board. 12 respondents indicated this was strongly the case and the other 10 considering it very strongly so. As can be seen from the more detailed commentary this endorsement is derived from both internal reflections but also the external governance environment as outlined in formal reports such as the Walker Review. Nevertheless there are, as can be seen, still some areas of concern regarding the wider understanding and appreciation of the role of an NED.

Comments included:

> *'Our role is to represent the members' interests and provide challenge, guidance and support to the executive in their responsibilities.'*
>
> *'Clear response to NED challenge and queries.'*
>
> *'In my earlier experiences in smaller societies, I was concerned that NEDs acted as "quasi-executives", which is clearly not our role. Much better in recent years with a clear recognition of our oversight role.'*
>
> *'Remember – in a mutual NEDs carry out the only oversight which exists as they are no owners to oversee the board.'*
>
> *'Execs realise and appreciate NEDs are "critical friends".'*
>
> *'Our ARROW (Advanced Risk-Responsive Operating FrameWork) results provide positive of our contribution.'*
>
> *'It's not easy to find good NEDs who have the time available and, where they still have exec roles, to make the switch to behaving as a NED.'*
>
> *'I just wonder how people can hold several NED roles … maybe this should be prescribed?'*

A number of respondees gave examples and case illustrations of how and where they had applied and asserted their influence in key decisions and policy/strategy interventions some of which remain confidential within the project team[34].

NEDs were also asked if they had seen any change in role or perception during 2009:

> *'There's an increased awareness of the importance and responsibility of the (NED) role in the society <u>and</u> as a representative of the greater community.'*
>
> *'The Walker Review has certainly increased awareness of the NED's qualifications, role and responsibilities.'*
>
> *'More active support for NED learning and development.'*
>
> *'The demands on those NEDs with real financial services experience are increasing considerably …. But the NED expertise on brand, customer service etc. is just as important.'*
>
> *'I am concerned about the trend of external regulation negatively affects NEDs. NEDs should not just be "policemen" – they should contribute to strategy formation and related decision-making. We need to hold on to the spirit of being a unitary board.'*
>
> *'Our exposure to staff and to members could be improved – staff perceive that NEDs are removed from the business.'*
>
> *'NEDs come into their own in times of strife … [such as in recent past].'*

[34] Some of these were undoubtedly of great strategic significance, but due to the confidentiality of the research cannot be detailed here.

'More aware of personal responsibility, especially if FSA go after individuals. Its at the forefront of our minds!'

'I think the (Walker) review and formal review goes against the culture of the Board we are trying to create here – more headteacher role and not the appropriate style for us.'

'Changes in the external world have emphasised the NED role, but much of this is at Board level and understanding lower down the organisation is lacking. We need to engage more with staff as well as members.'

<u>Q7 Training and preparedness for the role of NED</u>

It has long since been recognised that, to be effective, NEDs need suitable training (induction and ongoing) and material support. This has been extended in terms of requiring NED involvement in and chairing of key committees, and in growing expectations for board renewal and board appraisal/review. More specifically the Walker Review outlined recommendations for more extensive time commitments from NEDs to meet their extended responsibilities. Here we are interested in NED views on what was provided to assist with your preparedness for Board work and views on current and projected time commitments.

This was divided into two sub-questions: the preparedness for the role and secondly the projected time commitments as an NED.

Some found themselves well prepared for their role: 13 reported well designed induction and training and support with another 5 seeing some evidence of the same. But there were also 4 others who reported only modest preparation for their NED role. In terms of time commitment, 3 found it much more of a commitment than expected and another 16 more than expected. Only 3 found it as expected or less.

Comments were focussed on any changes in the NED preparedness since 2009 as well as more general views on induction and training:

'Bigger Board packs and more complex issues, all requiring analysis and comment.'

'More quality reports – we're all more aware of our responsibilities and our performance being in the spotlight.'

'Increased requirement for understanding trading areas of the business (ALCO).'

'Time commitment probably increased by 2-3 times from I when started and will increase again next year (2010).'

'Increased time inevitably reflects response to the crisis and the complexity of the regulatory changes that have ensued.'

'Time and the level of scrutiny will deter some candidates, so we may have a shortage of quality NEDs in the future.'

'Increased oversight/review by FSA.'

'Fees must be set to reflect demands on NEDs in the future ..'

'We are revamping our induction and ongoing training in the near future.'

'There's a longer lead in time now with FSA approval … this and general increased time commitment will mean the recruitment pool is likely to be retired persons.'

'We need people from within but also external to the sector (fresh faces, fresh minds) but there's a lot of sector terminology/jargon to come to terms with for new NEDs.'

'NED remuneration must increase if the inputs/outputs can be delivered. Smaller mutuals may find it even more difficult to compete from a limited pool of potential NEDs – especially if HQ is away from London.'

'Real challenge for Board/Committee Chairs, and for "Senior Independents".'

'NEDs are becoming scarce animals.'

Q8 Current confidence as NED

Here we are simply asking if, in the light of the widespread focus on the financial crises and general Board governance, this has impacted on NEDs confidence in their effectiveness and/or that of their fellow NEDs.

This was again divided into two sub-questions: confidence in the NEDs own role and then in the full NED complement on the Board. For the most part NEDs felt more confident in their role: 1 reported much increased confidence and another 16 some increased confidence. 3 were 'balanced' in their review and 1 less confident. For the second element, 15 reported much increased confidence in the NED presence on the Board and another 4 some increased confidence. 3 were balanced and 1 indicated a reduced confidence in the NEDs within the Board.

Comments with the questionnaire were quite limited, but the interviews brought out some further detail and insight:

'Events in 2009 acted as a 'test' and accelerated developments already underway'

'We are at risk of seeing ourselves as a separate (business) form, whereas we need the calibre and experience appropriate to the banking sector.'

'No real change in confidence either for myself or for my colleagues.'

'Over the past 5 years the Board has sought to adopt appropriate strategies that are risk-based … and to anticipate the requirements of the FSA and other parties that oversee the Society.'

'The FSA could have engaged NEDs much earlier in 2007/08 in the wake of the crisis …'

'I don't think my confidence level has changed, but we have probably all learned a few lessons.'

'Board confidence has increased collectively as well as at the individual level. We've had some previous decisions and strategies endorsed by some of the recent events.'

'The element of challenge has increased but also some evidence of better collective working within/across the Board and with wider Executive.'

'It feels better, more confident BUT NEDs must be prepared to step down if their independence compromised – this just doesn't happen enough in the business world.'

'More confident having navigated through the difficulties with good results.'

'Still feel we are compressed by regulation and it tends to makes us look backwards, when the fun bit is looking forward!'

Section Three Overview

In summary what we have identified is:

a) There is wide spread support and endorsement of the fundamental unitary board model and the contribution that NEDs make within the BSoc sector;
b) There has been an increased concern and focus on both induction processes and ongoing training for NEDs;
c) Many NEDs and board seem more confident in their individual and perhaps more specifically, the collective abilities and application of their colleague NEDs and boards having survived the initial challenges of the recession.

There are however areas of concern and pointers for further reflection:

d) Whilst the role and remit of the NED is understood within the Board, there are concerns that it is less well understood either by other key stakeholders both internally and externally;
e) Many NEDs feel both uncomfortable, and in some instances more fundamentally concerned, that their role is being framed ever more within the monitoring and 'watchdog' role rather than the strategy/control duality identified in the earlier literature material;
f) The NED appears to becoming ever more onerous and the time requirements and general involvement may increase the cost of NED appointments and reduce further the potential future recruitment pool;
g) Related to the above, and to the Walker Review expectations, there were also concerns that an increased weekly/even daily contribution may 'incorporate' them further into the organisation and organisational culture and blur the very independence of the NED;
h) There is a seeming resistance to formal appraisal, and little evidence of external, independent advice being sought or even considered in the way envisaged by Walker, beyond the usual internal/external audit support. NEDs need to consider periodically the benefits of greater exposure to external perspectives to prevent too insular an approach.

Section Four: The 'dividend of mutuality'

An important focus for building societies is on the need to continue to identify and demonstrate the benefits that mutuality confers, both to the member but also the wider range of key stakeholders. This has been described in various circles as the 'dividend of mutuality'. Here we are interested in NED views about what this means from their own perspective and with regard to their individual society. Here we used some commonly identified measures or indicators of mutuality.

This was in many respects an opportunity for the NEDs to reflect more widely on the Building Society sector and its business rationale and unique selling point(s). The overall response profile is tabulated below, but as with other questions, the insight is delivered in some of the questionnaire and interview responses.

Key indicator	Number of times ranked highest or joint highest in questionnaire response
Democratic Engagement with Members	12
Keener Pricing Policies (without shareholder dividend)	7
Member Friendly Practices	13
Longer Term Policies and Commitments	13
Mutual Culture	17

Further comments made were many and varied:

'We emphasise our mutuality by putting people before profit, and by ensuring that our profit is sufficient to grow the society – a good balancing act if we can get it right!'

'we need to maintain simple effective mutual values in support of a core objective – affordable home ownership.'

'Our objective is to remain a local, independent mutually owned building society and we have no intention of living beyond our means by offering products we cannot afford'

'To survive in the long-term mutuals must be given a fair and level playing field on which to operate. There appears to be little or no effort on behalf of various authorities [sic] to put things right despite warm words about mutuality'

'It is important that the mutual model continues as an alternative to conventional business, especially in financial services where public trust has taken such a knock.'

'It's a matter of frequent discussion, usually prompted by NEDs, but it's not fully understood by members and more could be made of it.'

A frequent point made was that internally, from the executive through to front line staff, NEDs did feel that there was a very positive sense of being different, providing a more community conscious and focused business offer. NEDs were very much aware however of the difficulty in making this connect with the membership and even more so with the wider public:

'Its an easy thing to talk about, but much harder to demonstrate and deliver.'

'We feel we have a very sound (potential) USP in being the only serious high street competitor to the banks, but we find it very difficult to communicate this USP to existing/prospective (mutual) members'

'I think the concept of mutuality is very confused in the building society sector, and possibly becoming more so. We need to start from the customer perspective and what mutuality can do for them, not the other way around.'

'I've always been impressed by the significant regard paid to mutuality in general and members in particular and this isn't the treatment some shareholders receive from PLC … BUT … until the current stresses are relieved and lending can once again become a viable reality, the concept [of mutuality] is destined to become a dinosaur'

'Mutuality is a state of mind for a business, but one not fully understood, or of immediate concern to the public. But they do understand different behaviour, and we are starting a journey to try to reinforce the mutual 'difference' in a way that might also appeal to a younger membership.'

7. **Summary Discussion and Conclusions**

The research has identified a series of views related to the three main areas of investigation:

1. What has been identified with regard to the Walker Review is:

    a) The need for proportionality in relation to the operational context and requirements of Building Societies, especially the smaller ones;
    b) A concern of over-emphasising the financial background of NEDs when NEDs identified a continuing need for board diversity;
    c) The key remains the human element and how boards work together. Here NEDs seem to endorse the view that *'the key to better corporate governance lies … in the social dynamics of board interaction, and in the competence, integrity, and constructive involvement of individual directors'*[35]

Looking at the competitive environment the current status was pre-dominantly one of 'weathering the storm', with NEDs expressing circumstances in the 'here and now' rather than over a longer period, or even medium term. This point is also identified in the next section.

2. Considering recent response to change and perspectives on risk, our research indicates:

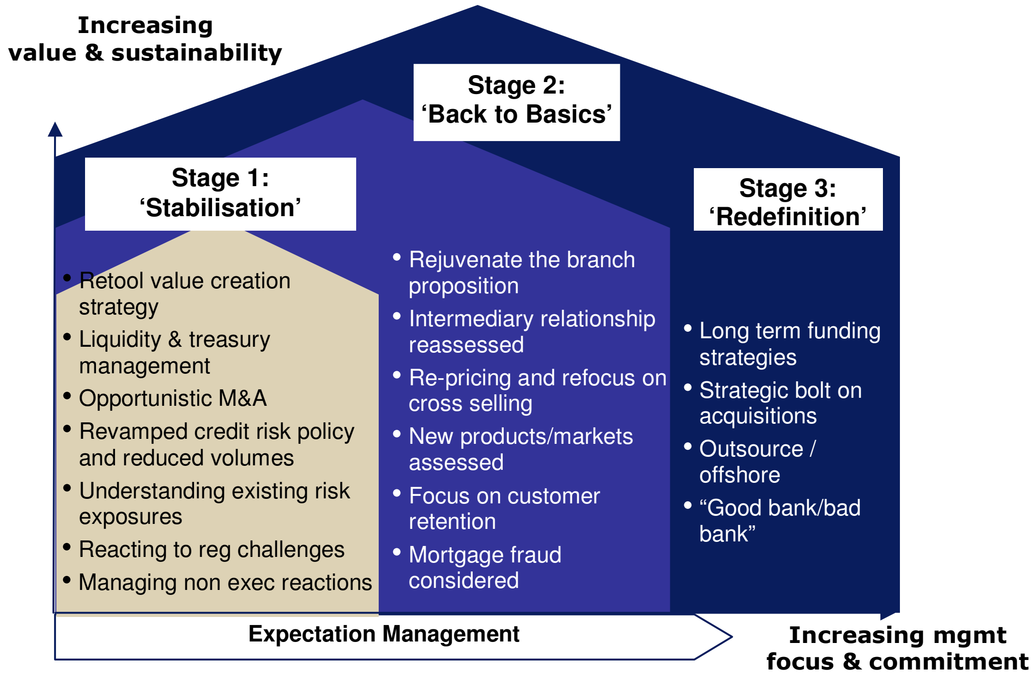
    a) A feeling of being better informed and equipped to consider and assess and manage risk in a focused and systematic way;
    b) Notwithstanding the above, a reluctance to adopt some of the organisational and structural changes envisaged by Walker (Chief Risk Officer; Board Risk Committee) either as a result of these being seen to be less relevant to the building society business model and/or financially challenging especially for the smaller societies – this, as noted earlier is within the expectations of Turner and Walker Reviews;
    c) Clear indications of a risk-averse sector or at least a desire to express a concern and a status in which 'risk security' was paramount, with some evidence that this was becoming more ingrained not just as a result of external scrutiny but as an expression of internal policy intent;
    d) A view that the focus on executive remuneration was also less relevant with the sector where shareholder bonuses do not exist. NEDs generally felt it was an exaggerated concern in this sector.

A challenge for NEDs in assessing risk is in considering the 'up-side' of risk i.e. in promoting and encouraging entrepreneurial activity. Deloittes review of the Building Society Sector[36] considered how building societies are approaching the 'weathering of the storm' noted earlier, outlining a three stage approach to expectation management. Deloitte's view is that *'Redefinition to deliver long term value will require focus on multiple improvement levers over a multi-year period – underpinned by effective management of market expectations'* (Deloitte 2009).

This is summarised graphically as in Figure 1 below:

[35] Nadler, D. (2004) 'Building better boards' Harvard Business Review May 2004, p.102
[36] Deloitte (2009) Building Society Sector: A Perspective. Seminar presentation December 2009, made available in private communication.

Figure 1: Building Society Sector Review – Projected Business Environment (Deloitte 2009)



Our research evidence is that NEDs have mentally positioned themselves within stages one or perhaps two, but there is much less evidence of being ready to shift to stage three, or any certainty that this can be achieved without some additional policy support from the government. This issue is also picked up again in the concluding commentary.

3. In respect of the role, remit and perspective of the NED, the research has identified that within the sector:

   a) The unitary board model is considered relevant and beneficial with NEDs emphasising their role within the building society sector;
   b) There has been a greater focus on induction and training for NEDs and NEDs are more confident in their individual and collective abilities.

Areas of concern are noted and further considerations are:

   c) More work may be required in developing understanding beyond the board, with NEDs wishing to emphasise their dual role as both 'watchdog' and strategists;
   d) The NED role does appear to be ever more onerous and this may present further challenges in terms of future recruitment as well as the potential for NEDs being drawn ever more into the business and, perhaps ironically, lose the very 'independence' they are there to provide;
   e) There is scope for boards to make use of further external, independent advice both in support of board appraisal but also in providing targeted and judicious advice on strategic areas and operational review e.g. to Chairs of key committees and to the Senior Independent Director (where such a post has been formally recognised).

In discussing the 'dividend of mutuality' we raised with NEDs some fundamental issues and discussion points about the nature of mutuality, its future competitive strengths and its relevance in the future. This has been a long-identified and admired business trait:

'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 customers, which even the best of plc structures find difficult to emulate.[37]

Those NEDs taking part in the research unanimously expressed a strong affiliation and sentiment towards the concept of mutuality (as one might expect!), but with a much less certain or convincing view of what that might mean for the future – one respondee noting for instance that there was as yet *'insufficient customer benefit from mutuality'*, and another noting that *'the comforting words of politicians and academics about mutuality are of little meaning if that isn't translated into something of meaning to future generations of consumers and, hopefully, [society] members'*. Both referred to a need to reinvent a meaningful model for mutuality. Put more directly, what does mutuality mean to anyone other than those who work within a mutual one, or have a past affinity to one? How does the younger consumer relate to such concepts?

Whilst the focus of the research was not specifically on the current and projected strategic position of building societies and the building society sector, this is inevitably a primary concern and discussion point for many NEDs. On this there seemed to exist a majority feeling that what currently exists is a temporary problem facing all financial service institutions and that some return to 'equilibrium' will, in time, occur. But even if *'the problems of those building societies that have encountered a decline in performance have been predominantly on the property market rather than funding models*[38] there remains both a short-term and a long-term challenge: short-term in sitting out a potentially protracted property down-turn; long-term in reflecting that the pre-recession history for the building society sector (as outlined in section 2 earlier) was one of gradual marginalisation against a range of aggressive competitors in the financial sector.

We should acknowledge that just as (excessive) risk taking and commercial exuberance is more common in a boom, then more extensive pessimism and risk aversion will also be seen in a recession, and these latter traits have been seen in some of the responses noted in this report. The expectation might then be that the pendulum will swing again. This then becomes central to NEDs seeking to assess the balance of risk, and in determining the level of risk aversion and risk acceptance: without some significant change the 'equilibrium position' for building societies is likely to remain challenging and even problematic. A niche position may suit some of the smaller societies: a key opportunity came from the local, personal and community focus although, referring back to the mutuality dividend debate, this competitive advantage derives from being small and locally responsive, and is not necessarily related directly to the mutual business model itself. For the medium and larger organisations a niche position may be more difficult or even untenable – a classic Porter[39] challenge of being "stuck in the middle" – too small for cost advantage but too large and remote from their mutual origins to effectively differentiate themselves.

From this view there seems to be a continuing pressure to merge and further rationalise, and even during this period of research those pressures have been evidenced in further merger activity. For some there is perhaps an inevitable move towards the "Snow White and Seven Dwarfs" scenario one of our respondents identified – a sector dominated by the Nationwide with a handful of other major, regionally dominant, players together with a rump of much smaller niche actors. Commentary from the BSA[40] would suggest that this may be an exaggerated perspective, with the recent mergers being a 'downturn' phenomenon, and that there is evidence that Building Societies are 'bouncing back' with fewer societies recording losses in 2009 compared to 2008.

Either way, the government could provide a real policy lead in reinvigorating the (mutual) building society sector. However if this is then restricted to the formation of a reformed government-endorsed

[37] Kay J (1991), 'The Economics of Mutuality', Annals of Public and Co-operative Economics, Vol 62 (3) pp. 309-318.
[38] Oxford Centre for Mutual and Employee-Owned Business (2009) Converting failed financial institutions into mutual organisations BSA p.13
[39] Porter M E (1985) Competitive Advantage: Creating and Sustaining Superior Performance.
[40] Feedback in correspondence, October 2010

mutual based on the Northern Rock, the competitive arena might simply intensify rather than radically alter for the majority of existing societies. Meanwhile other parties in the property arena may look towards alternative solutions to their own policy challenges either through necessity or perhaps strategic choice[41].

The challenge for building societies, and for NEDs within that sector, is to create and sustain an appropriate risk culture and appetite that will enable any such resurrection of the sector to develop and flourish: it is to explore opportunities and alternative approaches and solutions that both enhance the mutual concept and intention, but meet 21st century customer expectations and competitive challenges.

[41] A group of housing associations are drawing up plans to launch a £175 million bank to offer shared ownership mortgages: Inside Housing October 1st 2010

Appendix One: De-Mutualised Societies

All of these former building societies no longer exist as independent financial service institutes[42]

Bradford & Bingley	floated 4 December 2000. Mortgage book nationalised September 2008. Retail savings transferred to Abbey (Banco Santander) September 2008. Abbey rebranded to Santander on 11 January 2010.
Birmingham Midshires	taken over by Halifax, April 1999. Now a division of Lloyds Banking Group.
Northern Rock	floated 1 October 1997, currently in temporary public ownership.
Bristol & West	taken over by Bank of Ireland, 28 July 1997. Bristol & West transferred its branch network and savings business to Britannia Building Society on 21 September 2005. Britannia became part of The Co-operative Financial Services on 1 August 2009.
Woolwich	floated 7 July 1997, taken over by Barclays Bank in October 2000. Now exists only as a trading name of Barclays.
Halifax	floated 2 June 1997, merged with Bank of Scotland to form HBOS in 2001. In September 2008 Lloyds Bank agreed to take over HBOS. It became part of Lloyds Banking Group on 16 January 2009.
Alliance & Leicester	floated 21 April 1997, acquired by Banco Santander in October 2008. Alliance & Leicester is due to be rebranded to Santander in 2010.
National & Provincial	taken over by Abbey National, 5 August 1996 (ceased trading under this name).
Cheltenham & Gloucester	taken over by Lloyds Bank, 1 August 1995. Now exists only as a trading name of the Lloyds Banking Group.
Abbey National	floated 12 July 1989, acquired by Banco Santander in November 2004. Abbey rebranded to Santander on 11 January 2010.

[42] Building Societies Association consumer factsheet – accessed July 10, 2010

Appendix Two: Listing of UK Building Societies by Assets[43]

Rank by Group Assets	Name of Society	Financial Year Ended	Society Assets £m	Group Assets £m
1	Nationwide	04 April 2010	190,497	191,397
2	Yorkshire (2)	31 December 2009	25,194	22,722
3	Coventry (4)	31 December 2009	21,037	18,402
4	Skipton (1, 3)	31 December 2009	15,859	15,569
–	Chelsea (2)	31 December 2009	13,406	13,413
5	Leeds	31 December 2009	9,556	9,545
6	West Bromwich	31 March 2010	7,962	8,336
7	Principality	31 December 2009	6,213	6,219
8	Newcastle	31 December 2009	4,514	4,620
9	Norwich & Peterborough	31 December 2009	4,251	4,248
10	Stroud & Swindon (4)	31 December 2009	2,723	2,737
11	Nottingham	31 December 2009	2,600	2,600
12	Kent Reliance (5)	30 September 2009	2,251	2,257
13	Progressive	31 December 2009	1,664	1,664
14	Cumberland	31 March 2010	1,576	1,574
15	National Counties	31 December 2009	1,210	1,246
16	Manchester	31 December 2009	907	937
17	Cambridge	31 December 2009	908	904
18	Furness	31 December 2009	842	843
19	Saffron	31 December 2009	835	836
20	Leek United	31 December 2009	735	735
21	Monmouthshire	30 April 2009	649	650
22	Hinckley & Rugby	30 November 2009	644	644
23	Newbury	31 October 2009	629	631
24	Darlington	31 December 2009	584	583
25	Ipswich	30 November 2009	462	462
26	Market Harborough	31 December 2009	416	417
27	Melton Mowbray	31 December 2009	410	410
28	Marsden	31 December 2009	356	356
29	Tipton & Coseley	31 December 2009	350	350
30	Hanley Economic	31 August 2009	348	349
31	Scottish	31 January 2010	326	327
32	Dudley	31 March 2010	313	313
33	Loughborough	31 October 2009	278	278
34	Mansfield, The	31 December 2009	274	274
35	Teachers'	31 December 2009	257	257
36	Bath Investment	31 December 2009	252	252
37	Vernon	31 December 2009	246	246
–	Chesham (3)	30 November 2009	231	231
38	Harpenden	31 December 2009	198	198
39	Swansea	31 December 2009	182	182
40	Stafford Railway, The	31 October 2009	175	175
41	Chorley & District, The	01 February 2010	172	172
42	Beverley	31 December 2009	165	165

[43] BSA – June 2010

43	Buckinghamshire	31 December 2009	158	158
44	Holmesdale	31 March 2010	152	152
45	Earl Shilton	31 March 2010	99	99
46	Ecology, The	31 December 2009	94	94
47	Shepshed	31 December 2009	93	93
48	Penrith	31 December 2009	89	89
49	City of Derry	31 December 2009	38	38
50	Century	31 December 2009	24	24

The Co-Operative Bank, including Britannia, had total assets of £46,119m as at 31 December 2009

Notes:

(1) Skipton merged with Scarborough BS on 30 March 2009. As at 30/4/08 their Group assets were £2,852m
(2) Chelsea merged with Yorkshire on 1 April 2010.
(3) Chesham merged with Skipton BS on 1 June 2010.
(4) The Coventry merged with Stroud & Swindon on September 1st 2010
(5) Kent Reliance is currently proposing to re-structure itself as a new industrial and provident society, the Kent Reliance Provident Society together with a subsidiary bank, the Kent Reliance Banking Services.

Appendix Three: Key Questions for NEDs and the Board

1.	**Business model**
	Have you envisioned different business models for the future to ensure survival?
2.	**Mutuality**
	How do you articulate the benefits of mutuality for your society in ways which are relevant, meaningful and motivating to members and customers?
	How do you monitor and measure that the benefits are still important and relevant to your customers?
3.	**Opportunities**
	Do you have a predominant focus on financial risk and is the cautious culture inhibiting growth unnecessarily?
	Do you have a plan for when you will you be prepared to take more opportunities and more risk?
	Do you have management information that helps to focus attention on opportunities as well as risk?
	Can you quantify the long term risk of missing business opportunities now?
	How have you planned to develop internal skills to lead in more innovative and imaginative ways if the "old market" does not return?
4.	**Board and NEDs**
	Do you have succession plans that reflect the need for a diverse board that reflects all stakeholders and areas of risk?
	Do you remunerate adequately to reflect the change in responsibility and time commitments for NEDs?

FEGReG is the Financial Ethics and Governance Research Group, Business School, University of Huddersfield

Established in 2008, the research group brings together experience and expertise in the area of Financial Ethics and Governance from across the Business School acting as a significant focal point for research and scholarship in the following areas:

- Accounting ethics and social and environmental accounting
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Led by Professor Chris Cowton, Dean of the Business School, FEGReG consists of some nine full-time staff plus a number of associate members and PhD students. It produces a series of working papers and in addition to academic research and publications, FEGReG undertakes applied research projects and consultancy assignments.

Website: http://www2.hud.ac.uk/uhbs/research/fegreg/index.php

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He holds a lead brief within the Department of Strategy and Marketing for external business support and consultancy activity. Recent research/consultancy work includes:

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- consultancy support in developing a Board appraisal process and in administering the Board review/Board member appraisal for a regional housing association
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