Cold shoulder for the mutuals

Adriana Nilsson finds no clear way forward for building societies attempting to enter retail banking

The UK needs more diversity in retail banking. Both the Treasury Select Committee, in its report *Competition and Choice in Retail Banking*, and the Independent Commission on Banking, have stressed this. The difficulty, however, is in getting there. The challenge to the incumbents should, in theory, come from nimbler entrants, or smaller players like the mutuals. But it seems that incumbent retail banks are no more likely to be challenged now than before the crisis.

Part of the solution depends on the way political and technical guidelines translate into practice. But the changes of the past three years, and the new requirements already implemented, hardly point to a level playing field, particularly for building societies and other mutuals. While the problems can be solved, a few issues need to become concrete proposals at national and, in some cases, supranational (EU) levels.

Higher prudential requirements, for instance, affect every UK retail institution. They are, however, more complex for mutuals, which cannot raise equity in the capital markets. Hybrid capital, particularly Permanent Interest Bearing Shares (PIBS), is not deemed sufficiently loss-absorbent to count as tier 1 capital. There is nothing new here: capital issues for building societies were the focus of a Treasury report in March 2010 and the ICB also recognised the issue. Nevertheless, more than a year into a debate between building societies and regulators about new instruments, there is still no clear way forward.

Squeezing profitability further is the Financial Services Compensation Scheme, which perversely penalises lower-risk business models such as retail-funded institutions. The numbers are not negligible – interviews with CEOs in 2011 revealed that, for some institutions, the annual provision for the FSCS in 2011 could reach 15 per cent of profits.

These unresolved issues not only put pressure on balance sheets, which have shrunk over the past four years, but are barriers to long-term planning. Yorkshire Building Society and Coventry Building Society were touted as possible bidders for Northern Rock, but neither seemed able to formalise capital instruments to raise funds. Instead, the bank went to a consortium fronted by Virgin Money and mainly capitalised by the US private equity company, W. L. Ross & Co. In 2010, Kent Reliance, then the thirteenth-largest building society in the UK, ended up as a hybrid model (partially demutualised) after a recapitalisation by JC Flowers, the US private equity group, which subsequently failed to acquire Northern Rock and Principality, the UK's seventh biggest building society. While these are new entrants, it is legitimate to ask whether this is the competing business model the Select Committee and the ICB had in mind.

> Banking may become safer but not necessarily more diverse

The question becomes more pressing when one considers that restraints could lead to further demutualisation. In the UK, all building societies that chose to demutualise ended up state-owned, foreign-owned, or simply ceased to exist. One consequence was further banking concentration. According to the Building Societies Association, 51 per cent of national savings in 1987 were deposited with building societies and 31 per cent with banks. In 2010, mutuals had 18 per cent of the savings market, and banks 62 per cent. In the mortgage market, in 1987, building societies had a 71 per cent share, and banks 19 per cent. In 2010, building societies had 15 per cent, while banks had 79 per cent. This imbalance could be partially rectified if mutual institutions were to bid for Lloyds Banking Group's assets, particularly because institutions such as Nationwide, The Co-operative Bank and Yorkshire have good historical loan-to-deposits ratios. But even with reported interest on the part of the Co-op and Nationwide in Cheltenham & Gloucester, it is unlikely they would be able to acquire the whole lot.

New entrants and foreign competitors may lack the funds and, to some extent, even the appetite for growth. Tesco, although less affected by the new prudential requirements than building societies, has yet to enter mortgage and personal current account markets. The debut in the former was postponed to 2012 and the launch of personal accounts and branches has no set deadline. Moreover, the crucial question is whether the move to utility banking will push players such as Tesco and Virgin closer to, or further from, full service retail banking, considering return on equity is likely to fall. Some foreign banks, such as Handelsbanken, do not rely on expanding market share. Others, although admittedly a tiny number, may have a parent bank in a country with a more liberal regulatory approach, which can lead to retreat and/or cherry-picking in the UK.

While banking may become safer, this will not automatically translate into diverse banking. Mutuals, in particular, need to be considered. Also, will the new Financial Conduct Authority, which should promote competition, have the clout to interfere? The relatively small number of alternative players and their weak lobbying power compound the problem.

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