

**19 June 2009**

**The Walker Review  
A Submission by the Building Societies Association**

**Introduction**

1. The Building Societies Association welcomes the opportunity to contribute to the Walker Review. We represent all 53 UK building societies. Building societies have total assets of £385 billion and, together with their subsidiaries, hold residential mortgages of almost £250 billion, more than 20% of the total outstanding in the UK. Societies hold over £240 billion of retail deposits, accounting for more than 20% of all such deposits in the UK. Building societies also account for about 37% of all cash ISA balances. Building societies employ over 51,500 full and part-time staff and operate through more than 2,000 branches.

2. Clearly the background to the Walker Review is the shortcomings that have been evident in the quality of decision-making of bank boards. It should be recognised, of course, that whereas the Combined Code, which provides guidance on boardroom good practice, applies to all listed companies (and with suitable adaptations to reflect their mutual status is applied to building societies as well), in financial services there are extensive additional regulatory requirements which go well beyond those of Combined Code in its requirements of firms and individuals.

3. Expectations of what can be achieved by corporate governance need to be realistic. Enhanced corporate governance can help in raising standards of decision making and risk management, but it is no panacea and has to be seen in the context of a wider approach that includes effective supervision of firms and, in particular, those pursuing riskier business models and those of a size sufficient to be of systemic importance.

4. The FSA is already taking steps to address this via its Supervisory Enhancement Programme – and with its proposals for a new specialist sourcebook for building societies, that is intended to make its supervision of building societies more efficient and transparent (FSA CP09/17 refers). The BSA is still digesting the implications of the draft specialist sourcebook, and it may yet be subject to change. However, to the extent that the FSA calibrates building societies according to the level of sophistication of their respective business models - a key element of the draft specialist sourcebook proposals - it will make sense for the corporate governance requirements of societies to take account of such calibration.

5. The BSA approaches the Walker Review with an open mind. We consider that building societies have a good, and improving, record on corporate governance – and this was acknowledged by the Myners Review of the corporate governance of life mutuals in 2004. But we accept there may be room for further improvement and would urge strongly that the Walker Review views corporate governance in the context of the various regulatory and supervisory initiatives set in train by the Tripartite authorities, further recognises the diversity in both size and business model that exists within the building society sector, and the important differences between the mutual and PLC models.

**Building societies and corporate governance**

6. The FSA Regulatory Guide for Building Societies provides guidance to building societies on their corporate governance. This includes, for example, FSA's view that all building society boards should have a clear majority of non-executive directors (NEDs), including the chairman. In practice all building societies comply with this and have always had a majority of NEDs. Building Society law draws no distinction between executive directors and NEDs

in relation to their duties as directors. (A detailed analysis of building society board structures has been provided to the Walker Review team.)

7. The FSA Regulatory Guide also encourages building societies to have regard to the Combined Code on Corporate Governance. To assist societies in this, the BSA produces an annotated version of the Combined Code [http://www.bsa.org.uk/docs/corporategov/bsa\\_guidance\\_sept08.pdf](http://www.bsa.org.uk/docs/corporategov/bsa_guidance_sept08.pdf) – which provides guidance on how the Combined Code which, of course, is addressed to listed companies, can best be applied to a mutual. We also monitor societies' compliance with the Code and this shows a high level of compliance within the building society sector. (An analysis of societies' compliance with the Combined Code has been provided to the Walker Review team.)

8. Building societies tend to be risk-averse institutions, with simple business models, ie taking deposits from mainly retail customers and lending predominantly for the purchase of residential property. There are statutory constraints, under the Building Societies Act 1986, that require societies to be funded mostly from members' shareholdings (ie savers' deposits) and to lend predominantly against the security of residential property. Building societies are also precluded from engaging in riskier activity – such as trading on their own account. Whilst there has been diversification within the sector, this has tended to be carried out incrementally and prudently. There have been a handful of exceptions to this; notably, of course, Dunfermline Building Society, which have come to light during the current, unprecedented, market turmoil. But these are very much aberrations rather than the rule.

9. Building societies take risk management seriously. Effective risk management is central to the culture of building societies, and many building societies have board committees, responsible for risk management either solely or jointly with other responsibilities.

10. Whilst building society legislation requires societies to include details of directors' remuneration only in their annual reports, in practice building societies go much further than this. In 2008 92 % of building societies included details of directors' remuneration and the policy that underpins it in their summary financial statement – which goes to all members with savings, or a mortgage loan, of £100 or more.

11. The remuneration policies of most building societies take account of the longer term performance of senior management as well as shorter term goals. Moreover, their remuneration policies are subject to annual votes by members. Unlike PLCs, where advisory votes on remuneration policy are mandatory, for building societies such votes are voluntary, yet all but two, very small, societies conducted such votes in 2008, accounting for more than 99% of the total membership of all building societies. These ballots result in substantial endorsement by those members who vote, of societies' policies in this area.

12. Similar considerations apply in respect of risk management functions. The Turner Review has suggested every institution should have a main board director with responsibility for risk management. In smaller institutions, such as most building societies, the risk management role will of necessity be combined with other responsibilities, such as compliance.

### **More professional NEDs?**

13. The capacity of non-executive directors to challenge the executive depends on the quality, skills and experience of the NEDs. Most building societies have recruited directors with expertise in the areas of business in which the society operates. Where societies have expanded into new spheres they have tended to recruit NEDs with experience of the new business areas in order to challenge the executive.

14. Training is available to building society non-executive directors in complex areas. The BSA assists in this by providing a range of seminars and workshops for non-executive

directors, that are offered in conjunction with experienced market practitioners (we have provided details of these to the Walker Review team). NEDs are able to obtain independent advice at the society's expense where necessary, as provided for in the Combined Code.

15. The Treasury Select Committee recently argued for all bank NEDs to have a banking or other financial qualification. Whilst we understand why they have proposed this, the merits of such an approach are questionable. In terms of the skill set of NEDs, the BSA's analysis shows that the majority of building society directors do have financial or financial services expertise. (A detailed analysis has been provided to the Walker Review team.) It is, of course, invaluable for any board to be able to draw upon independent technical expertise but there is merit, too, in having NEDs with a more general perspective. It is often not necessary for directors to go into the minutiae of the detailed technical matters dealt with by the executive in complex areas; rather, at least some non-executive directors should be asking wider, searching, questions about the impact of complex or technical issues on the overall strategy of, and risks faced by, the business.

16. The Turner Review has floated the idea of more professional NEDs working "weeks rather than days each month" and with dedicated secretariat support. We have a few thoughts on this. First, it is not the role of NEDs to provide a parallel decision-making mechanism alongside the executive and to do so could undermine the executive and blur accountability, threatening the cohesion of the unitary board (we see no reason to depart from the concept of the unitary board). Second, a move towards fuller-time NEDs risks institutional capture, ie that rather than enhancing their independence, greater proximity to the day-to-day business, would diminish their ability to be objective. Third, it potentially raises resource issues. Most building societies are regionally-based and all have their headquarters outside of London. Geographic and demographic constraints mean the pool in which some building societies 'fish' for NEDs can of necessity be quite small. It will be further diminished if the requirements of NEDs are to be increased to unrealistically high levels.

### **Differences between building societies and PLCs**

17. The relationship between the board and those to whom it is accountable – is different in a mutual and a PLC. Building societies have individual members rather than the institutional shareholders that banks have.

18. There are differing financial objectives in mutuals compared to PLCs – for example, in normal times many mutuals seek to narrow their margins in order to give their customers - who mostly are also their members, a better deal. PLCs tend to seek to widen margins in order to deliver dividends to shareholders.

19. Building societies cannot undertake very big changes to their business without seeking member endorsement. A proposal by a building society to spend more than 15% of the capital of the organisation on an acquisition or investment outside the society's mainstream business would require approval by members in a general meeting – (although it should be noted that this legislative provision has never been used). Accordingly, members – to the extent that they are prepared to exercise their right to vote – have a say in the investment of any significant proportion of the risk capital.

20. Like PLCs, building societies are influenced by market forces – they decline in size, or grow only slowly, if they do not offer the savings accounts and mortgages which the market demands. The rating agencies, the media, including a vigilant personal finance press and a number of influential web sites, and the FSA exert considerable external pressure on societies.

21. While, arguably, listed companies are subject to the influence of their shareholders they are less subject to the influence of their customers than are many mutuals. It is not clear that some of the branch closure programmes, executive pay packets, and approaches to

service and product provision and pricing that some banks have implemented in recent years would have occurred had the directors of these institutions been accountable to their customers in the same way as directors of building societies are. Moreover, building societies score better than banks in providing customer service. This is illustrated by independent research commissioned by the BSA in 2008.

<http://www.bsa.org.uk/docs/publications/service09full.pdf>

22. Building societies clearly do not have major shareholders, so those aspects of the Combined Code that relate to relations with major or institutional shareholders do not apply directly to societies. But the BSA, in our guidance on the Combined Code

[http://www.bsa.org.uk/docs/corporategov/bsa\\_guidance\\_sept08.pdf](http://www.bsa.org.uk/docs/corporategov/bsa_guidance_sept08.pdf), encourages societies to relate to their individual members those parts of the Code that apply to major

shareholders. This pushes at an open door, in the sense that building societies have been placing increasing emphasis in recent years – and certainly since the demutualisations of the late 1990s – on managing their relations with members and encouraging members to become more involved in, for example, voting at building society AGMs, and participation in board advisory panels. A BSA publication, *Making Mutuality Matter*, reports on the wide variety of initiatives by building societies to promote member engagement.

[http://www.bsa.org.uk/docs/publications/member\\_engagement.pdf](http://www.bsa.org.uk/docs/publications/member_engagement.pdf)

## Conclusion

23. Building societies already take corporate governance very seriously. To the extent that failings in governance have contributed to recent problems in financial services, we would not suggest that societies are immune, although mostly societies have performed better than banks. This has been recognised by the FSA; for example, in its current consultation paper on a specialist sourcebook for building societies when it said:

“Although building societies, like banks, have been weakened by adverse economic and financial market conditions, the extent of that weakening has to date been less than that experienced by the banks – mainly because of the lower exposure to wholesale funding and complex financial instruments”.

*(FSA CP09/17: A Specialist Sourcebook for Building Societies, June 2009)*

24. The in-built majority of NEDs on all building society boards already affords them a different perspective to those of PLC boards, as do their close relationships with members who are also their customers. Taken together with the impending new specialist sourcebook for societies, and the fact that many building societies are small and regionally based, we see a strong case for the Walker Review’s proposals to be calibrated so as to recognise the particular circumstances of building societies.

25. It will be important for the Walker review to ensure that the measures it recommends are proportionate – for example, the corporate governance framework appropriate to a multinational full-service bank with a large trading book is unlikely to be suitable for even a large building society. Similarly, the corporate governance framework appropriate to a large building society is unlikely to be wholly suitable for a small society.

26. Whilst the experience of Dunfermline shows that building societies are not immune from the dangers of poor decision making and business oversight that have befallen parts of the banking sector, it is true to say that the generality of societies, are decidedly risk-averse. It is essential that the Walker Review takes full account of this - and of the context of the parallel regulatory and supervisory initiatives that are currently in train.

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