

# *The Simultaneous Fall and Rise of Mutuality*

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# The fall and rise of mutuality

- Why are financial mutuals converting to shareholder ownership, when mutuality is the form of choice for the revival of local community action through, *inter alia*, credit unions, and is also held out as the way forward for the delivery of public services in health and education?

# Defining mutuality

- ‘Customer-owned enterprise’: mutual life assurance companies, building societies
- Cooperatives and ‘non-profits’
- The ‘mutual state’: a private sector mechanism for the delivery of public services

<b>Customer-owned</b>	<b>Worker-owned</b>	<b>Investor-owned</b>	<b>‘Non-profits’</b>
<p>Mutuals:  building societies,  mutual life assurance companies,  retail cooperatives,  etc.</p>	<p>Law firms</p> <p>Employee cooperatives</p> <p>Producer cooperatives</p>	<p>Companies limited by share capital</p>	<p>Charities</p> <p>Public interest companies</p> <p>Companies limited by guarantee</p>

# The functions of mutuality

- Reducing transaction costs
- Allowing for ‘credible commitments’ in long-term contracts
- Managing divergent interests
- Reinvesting the surplus for future generations
- Lowering the cost of capital
- Facilitating collective action by lower and middle income groups

# Mutuality as a governance structure

- Cummins, Weiss and Zi (1999): ‘the owner-policyholder conflict is likely to be relatively high in the stock ownership form because stockholders have an incentive to expropriate value from policyholders by taking actions such as changing the risk characteristics of the firm after policies have been issued.’
- Drake (1997): equity shareholders enjoying limited liability would want a higher risk profile for the firm than depositors: but ‘in financial mutuals this aspect of the agency problem is absent as owners and customers are one and the same’

# When is mutuality efficient?

- Hart and Moore (1995), Valnek (1999): mutuals will work well where they have a *homogeneous* clientele.
- The history of the mutual form suggests that it can evolve to offer solutions to the presence of *heterogeneous* interests, such as those of borrowers and savers: the transition from the terminating to the permanent building society
- But mutuality, in itself, doesn't necessarily solve the agency problem: consider the *Equitable Life* case; and the recent history of building society demutualisation

# Empirical evidence on mutuals vs. plcs: risk

- Cummins, Weiss and Zi, 1999: study of US property insurers shows that mutuals and investor-owned companies operate on ‘different production and cost frontiers’ and hence attract different types of business
- Smith and Stutzer (1995): financial mutuals are better placed to deal with moral hazard arising from information asymmetries
- Valnek (1999): investor-owned banks incur higher costs in the form of loan-loss reserve provisions
- Born et al. (1995): mutual insurers are better at screening for excessive risk, but provide fewer lines of business and are geographically more concentrated

# Mutuals v. PLCs: governance

- Mayers, Shivdanasi and Smith (1997): US mutual insurers were more likely to use independent directors and specialised board subcommittees than commercially owed insurers;
- and in the case of mutuals, the presence of independent directors was correlated with reduced ‘value extraction’ by managers in the form of high salaries and perks, whereas, in the case of commercial banks, there was no such relationship

# Mutuals v. PLCs: profitability

- Drake (1997): in the period 1970-1994 UK building societies had lower cost to income ratios than commercial banks and higher and less volatile profitability
- Valnek (1999): in the period 1983-1993 UK building societies had significantly higher returns on assets and higher net incomes than banks, an advantage which translated into superior savings and borrowing rates
- Association of European Cooperative and Mutual Insurers (2001): during the 1990s European mutual life insurers had higher premium growth than life PLCs, and lower expense ratios (operating expenses as a % of premium growth)

# Mutuals v. PLCs: customer value

- Consumers' Association 2001 *Mutual Advantage* Survey: if the Nationwide BS were to convert to PLC status, savers and borrowers would pay an extra £33 billion in higher mortgage costs and lost interest on savings
- 'Building societies deliver better value for one simple, crucial reason. The priority of the shareholder-owned banks is to keep their shareholders happy by paying large dividends, and increasing profits...we calculate that for every £100 in after tax profit the banks make, about £30-£40 of that goes to shareholders as dividends...'
- *So how can we account for demutualisation?*

# The evolution of mutuality

- The origins of building societies
- The pre-1986 model
- The post-1986 model
- Demutualisation: winners and losers
- The survival of the fittest?

# The origins of building societies

- The terminating society
- The permanent society
- Limited competition
- Post-1945 expansion
- A ‘non-profit’ form?
- Deregulation: the Building Societies Act 1986

# The pre-1986 model

- The ‘straitjacket’: limitation of objects
- One member, one vote
- Complex rules for transferring or and winding up societies
- Attenuated property rights
- Boards as ‘trustees’: the non-profit form

# The post-1986 model

- Conversion: unlocking the residual
- Hostile takeovers through proxy fights
- Ineffective safeguards against predation
- Abbey National litigation
- The arrival of the carpetbaggers
- The response: PIBs, charitable assignments

# Effects of (and explanations for) demutualisation

- Managerial entrenchment and value extraction
- Windfall gains to carpetbaggers
- Losses to borrowers and communities
- Loss of choice and diversity

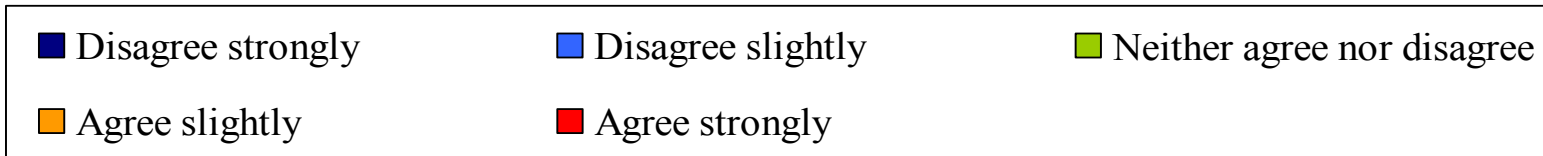
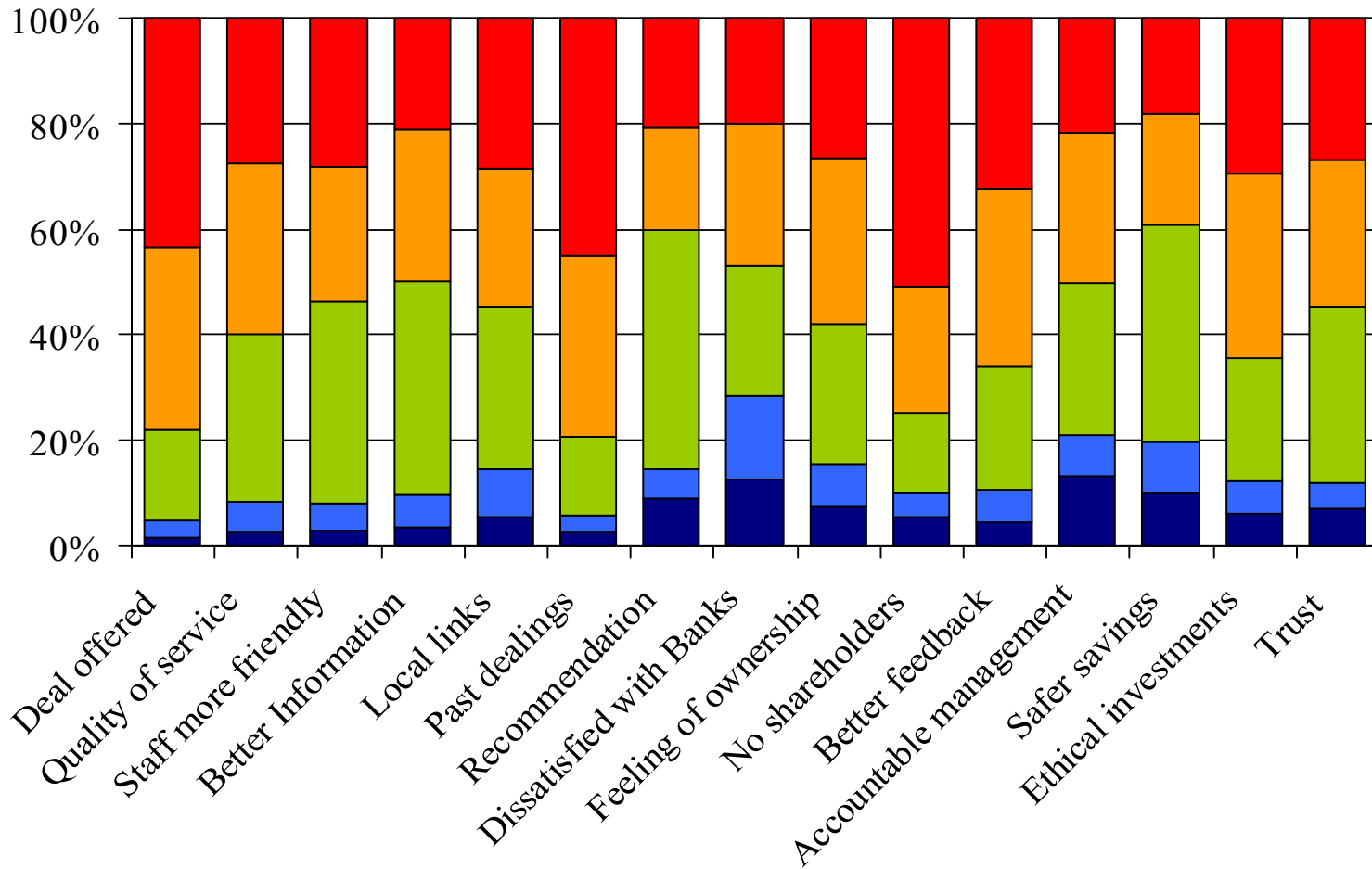
# The return of mutuality?

- The revival of regional building societies and coops
- Local credit unions filling the gap left by demutualisation in the building society sector
- Adoption of the mutual form in the public sector: foundation hospitals and non-profit utilities

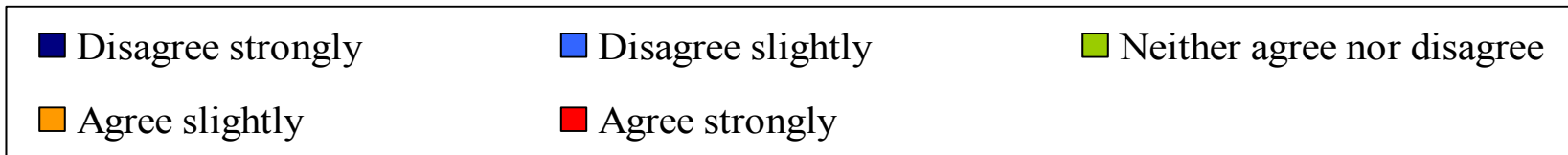
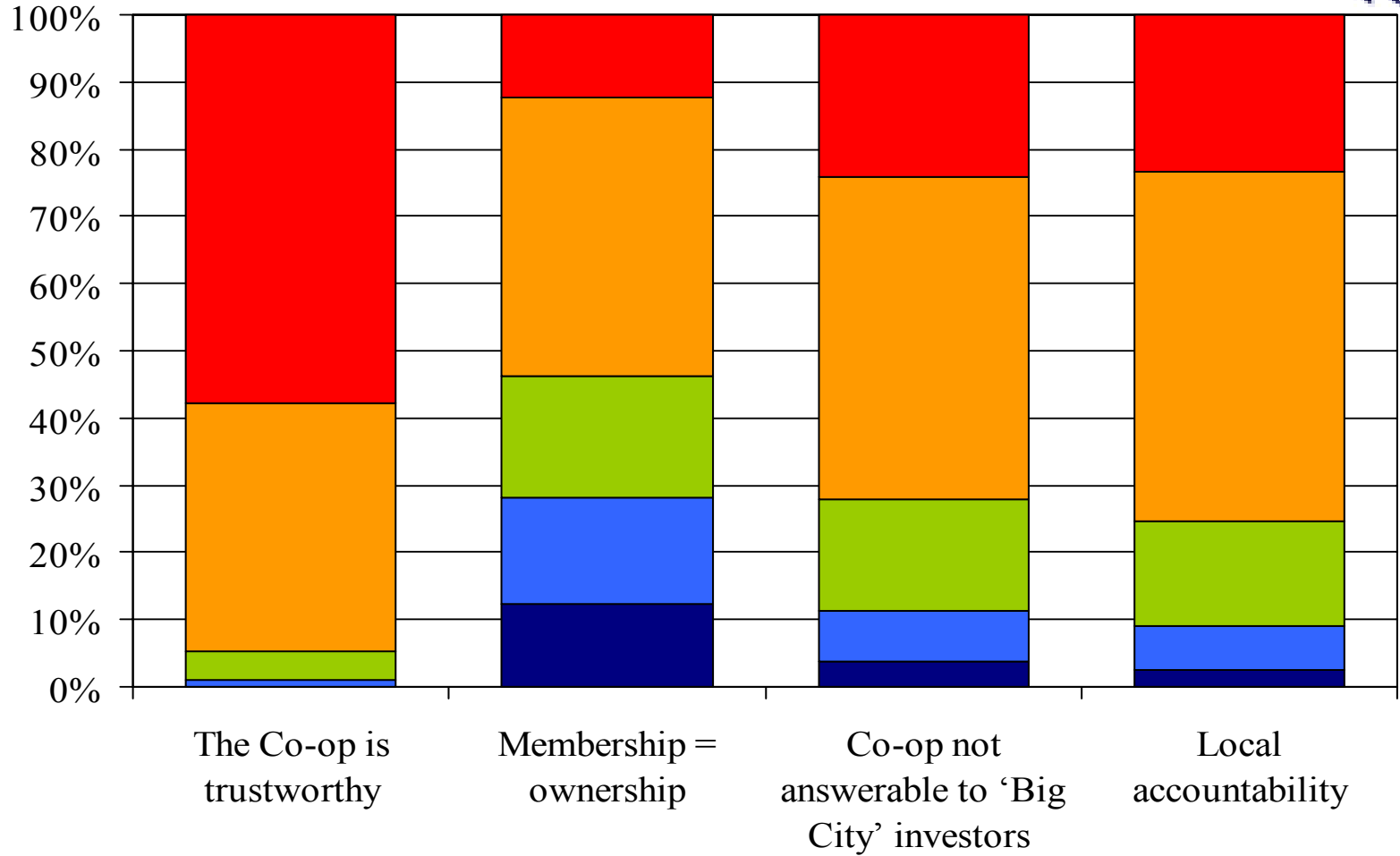
# The new mutuality: regional building societies

- CBR/Mutuo Survey 2003
- Member surveys in Yorkshire Building Society and Oxford, Swindon & Gloucester Co-op
- Follow-up survey to further investigate the factors leading to increased trust in mutuals
- A nationwide survey of first time house buyers to validate the results

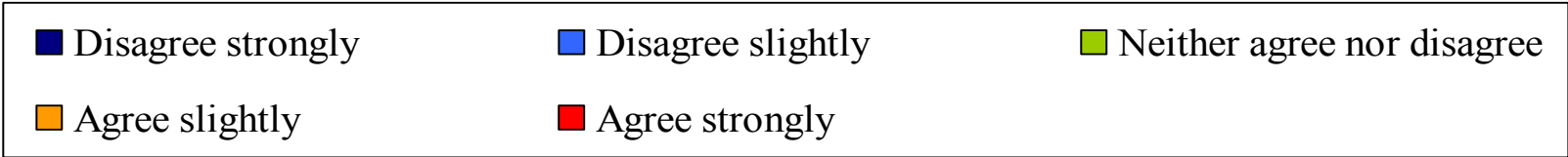
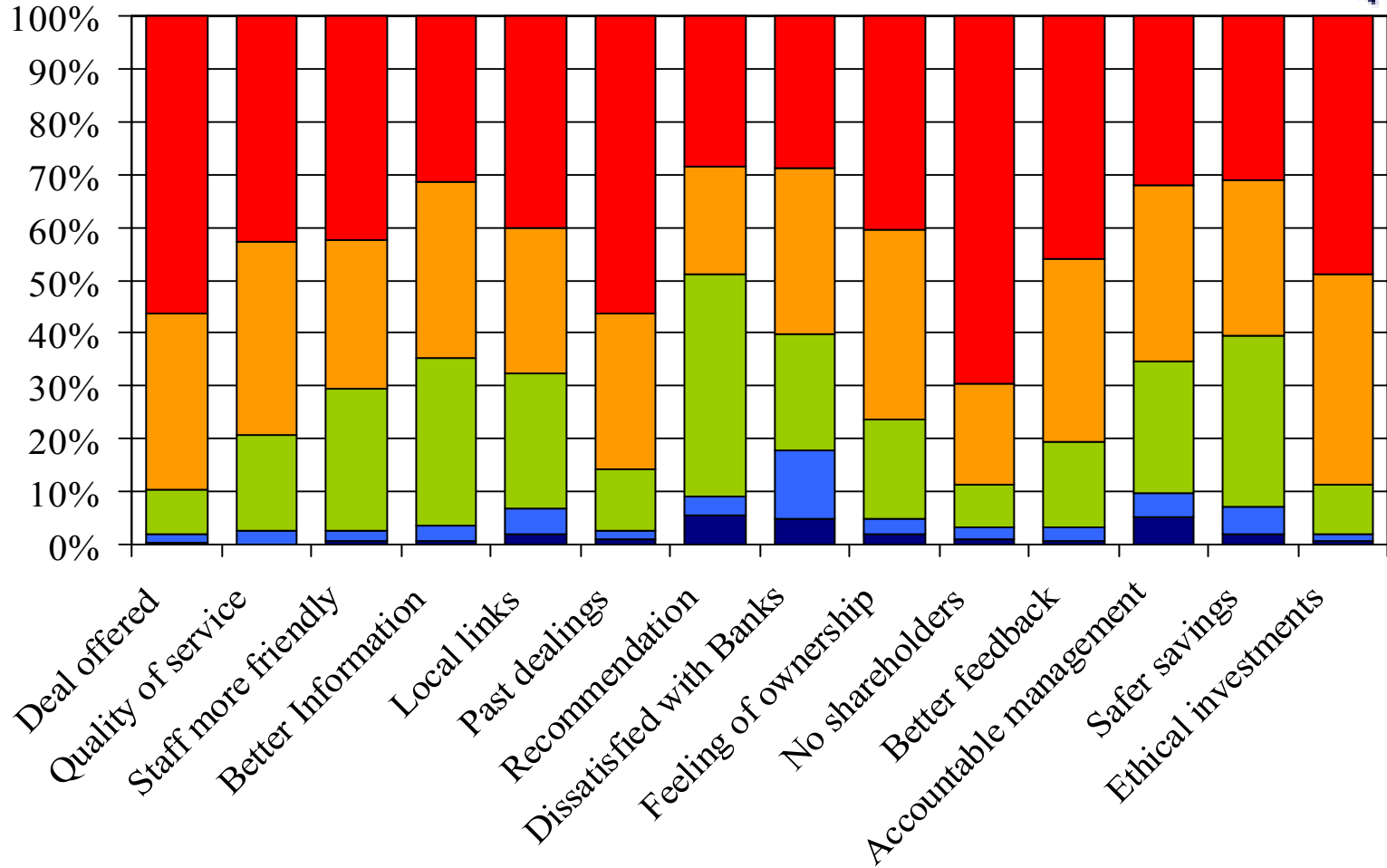
# Customers Reasons for Choosing a Building Society



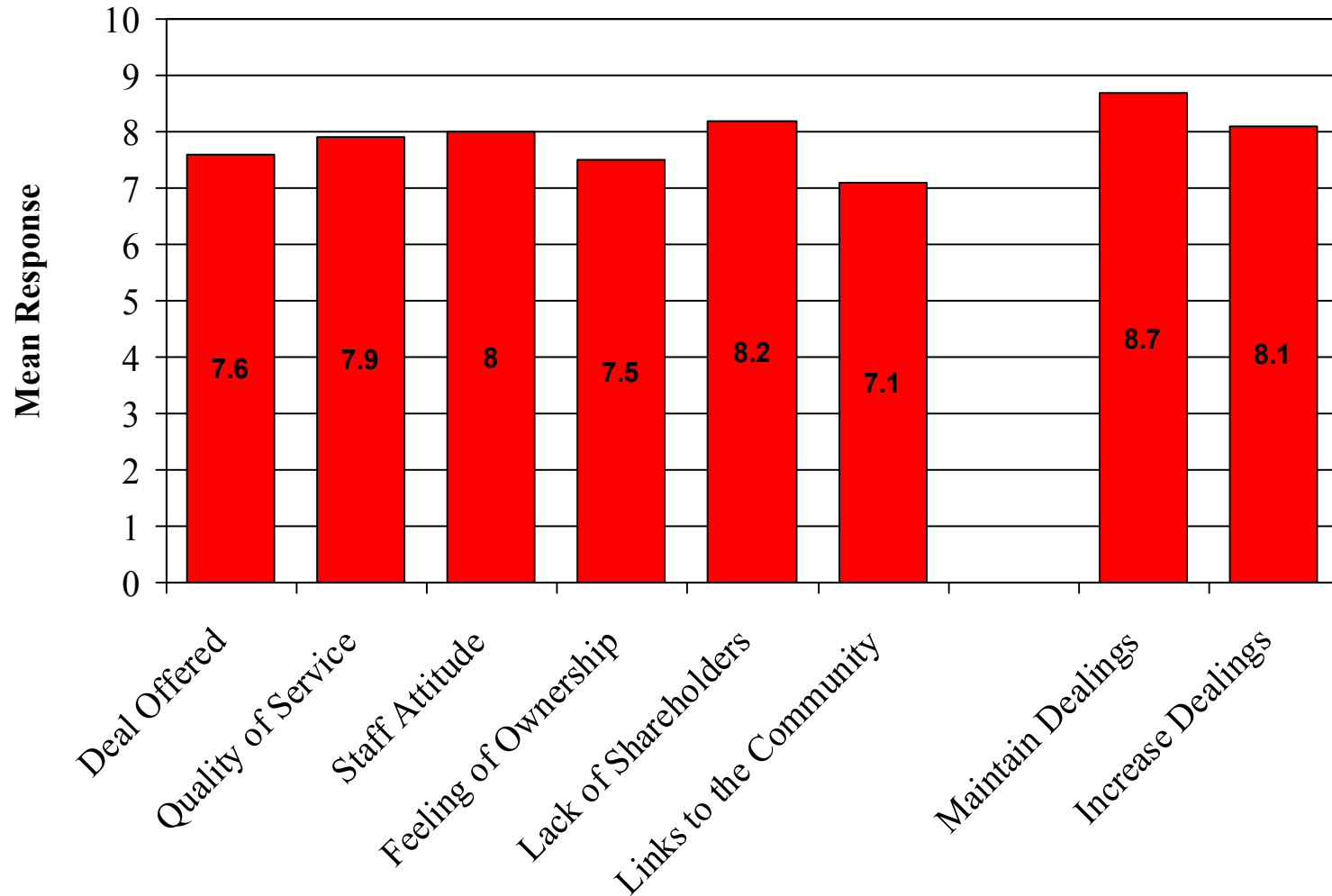
# Co-op Member Attitudes



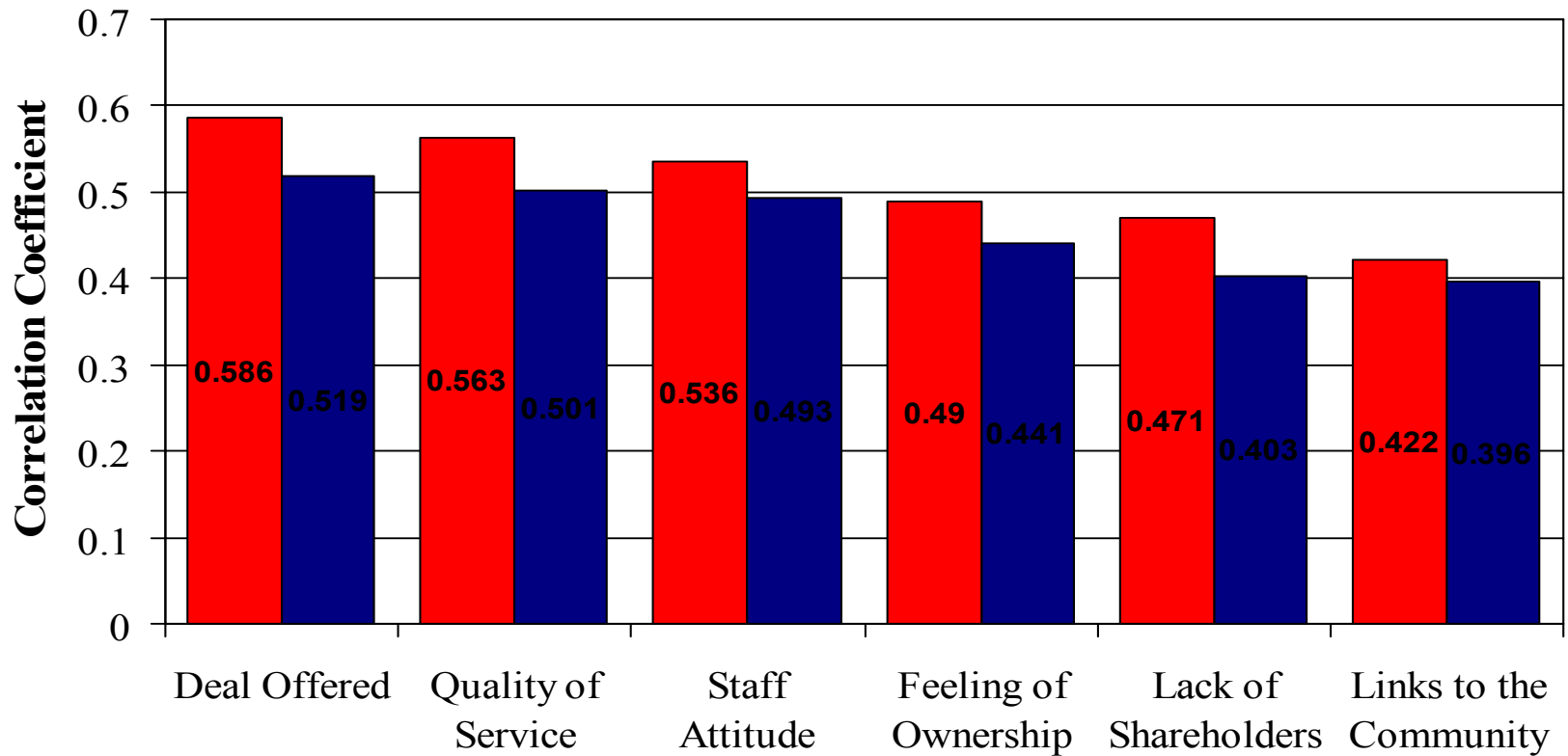
# The Association Between Trust and Other Factors



## Reasons why Customers Trust Building Societies

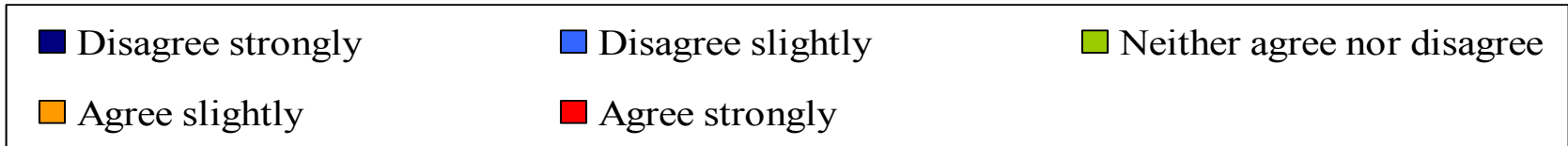
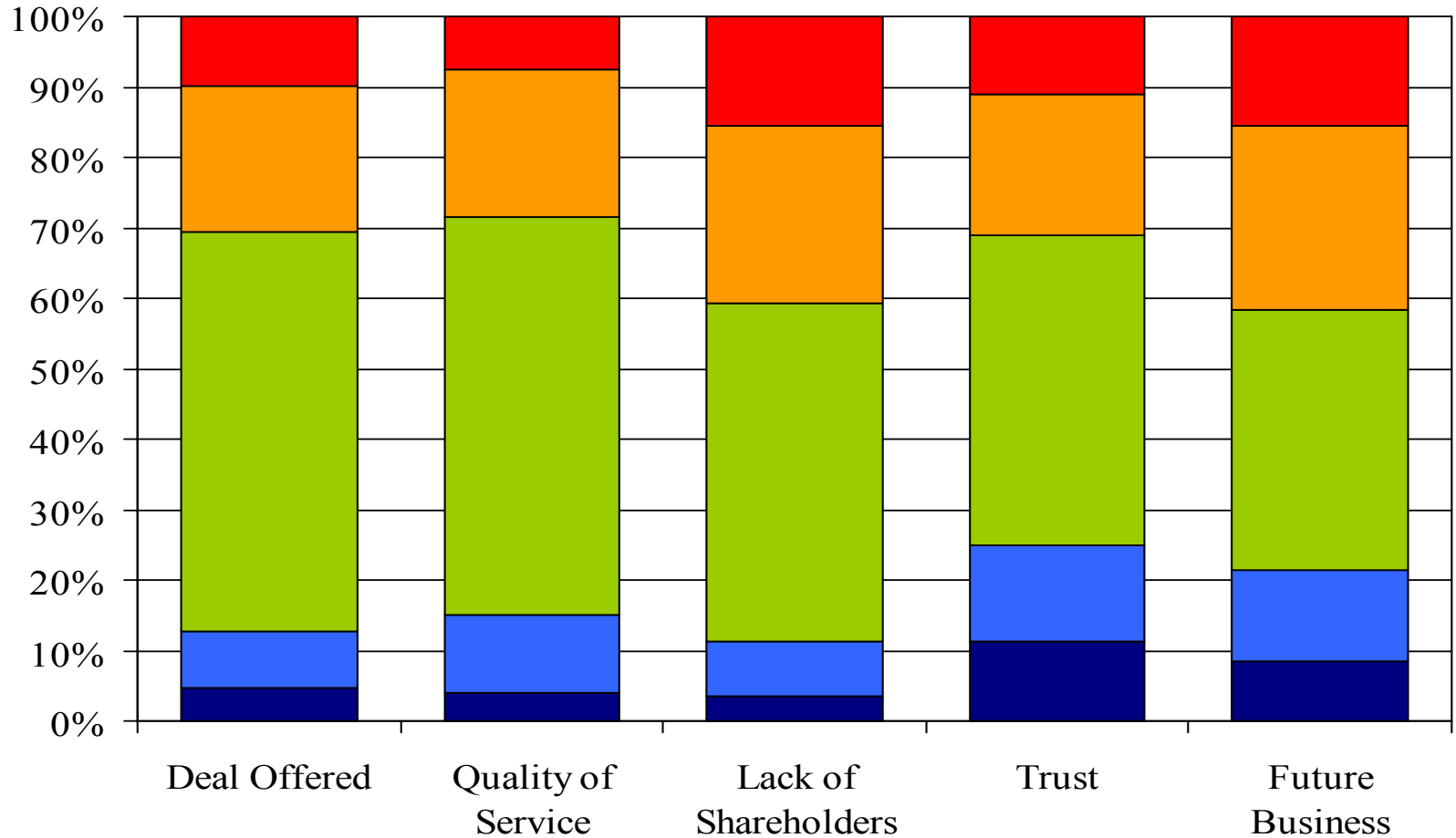


## Correlations Between Trust Factors and Future Behaviour



■ Maintain Dealings    ■ Increase Dealings

# First Time Buyers' Attitudes to Building Societies



# Conclusions from the surveys

- Mutual organisations enjoy higher levels of trust than their non-mutual counterparts
- Their distinct ownership structure is an important element of the ‘mutual advantage’
- The lack of external shareholders is more appealing to members than the abstract notion of ownership
- Factors such as quality of service and the deal offered are also strongly associated with trust
- Increased trust levels translates into increased business and customer loyalty

# Case studies in 'new mutuals'

- Yorkshire BS
- Oxford, Swindon and Gloucester Co-op
- Co-operative Bank
- Travelcare
- Norwich and Peterborough BS

# Common themes

- Selling on the basis of customer needs
- Seeing customers as members affects the way products are designed and marketed
- Member involvement in governance processes = vital information flows
- Focus on customer loyalty built up over time
- Customers increasingly value cooperative and mutual approaches

# Distinguishing between mutuals/coops and PLCs

- ‘The highest goal in a Society is to build the number of happy customers buying a larger number of products. There are three issues: the number of customers, maintaining a very high level of satisfaction, and the relationship between costs and products. These three represent the company’s ultimate focus for the management. I would regard it as a highly successful tenure if I double the customer base with very happy customers buying more products from us. We’ll then be a bigger society which people will think well of, as evidenced by the fact that we’ll have more members. The return on capital requirements which we have are simply a means to that end, whereas in the PLC, happy customers are the means to a higher return on capital. That is a key difference and it means that we don’t maximize profits, we run profits as much as we need to in order to get the balance of growth right’

# Distinguishing between mutuals/coops and PLCs

- ‘Our sales philosophy is, we are in the game of identifying and meeting customers’ needs. What that means is, rather than the hard sell, we prefer to enter into a dialogue with customers to see what kind of products they need... I would argue that a PLC’s philosophy on that would be, maximize sales opportunities to maximize profit... Mutuality helps us get closer to our customers because we can genuinely say, we are here to look after you.’

# Distinguishing between mutuals/coops and PLCs

- ‘You are acquiring [with an offset mortgage] a double relationship, you have a savings relationship and a lending relationship, and the minute you get a double relationship, you are then creating value for the mutual... The idea with a PLC is that you *lock* the customer *in*. I would say that with a mutual, you are getting the customer to *lock-on*. Totally different. The whole tone, the whole motivation, the whole aspiration is different.’

# Distinguishing between mutuals/coops and PLCs

- ‘The essential point is that a PLC owes its duties to its shareholders; we owe our duties to our members. It is easy for a PLC to make attempts to blur that distinction... but at the end of the day they are presented with an inescapable fact: the interests [of shareholders and customers] conflict... We only have to consider the interests of members present and future.’

# Conclusions from the case studies



- Being a mutual or cooperative matters in terms of employee training and motivation, product design, marketing strategy, and orientation to the community
- Mutualls and coops have a better idea of their own mission and are increasingly confident that they can offer customers a better deal than PLCs

# Credit unions

- Community banks, pooling savings to supply low-interest loans
- Members pay a fee and save regularly with the union; after a qualifying period, they may take out loans at a low rate of interest
- One member, one vote
- Common bond (employment, locality) leads to low default rate
- Promoting financial literacy through ‘self-help’
- Growing rapidly in the 1990s, *but* still local in character; questionable whether they can fill the gap left by building society demutualisation

# The mutual state

- ‘The key issue...is that communities and individuals need to be involved, alongside the State and professionals, in the design and delivery of public services...Under the Mutual state, new forms of entrepreneurial citizenship would emerge that involve the pooling of risk – through mutual social enterprises – rather than simply the pooling of resources... In order to pool risk effectively, such social enterprises would need to take new forms of mutuality and/or new forms of social investment.’ (Mutuo)

# Forms of the mutual state

- Public interest companies and ‘non-profit’ utilities: Railtrack, Glas Cymru
- ‘Foundation trust’ hospitals and other health cooperatives

# Foundation Trusts

- ‘having a clear public sector ethos and not-for-profit basis’
- ‘giving greater control to patients and service users’
- ‘more active involvement and control for both staff and management’
- ‘offering freedom from “top-down” management from Whitehall
- ‘immunity to takeover from organisations which will not provide such benefits’

(Alan Milburn ‘mutualisation announcement’ of January 2002)

# A viable model?

- ‘how should proponents of mutuality react towards these new kids on their block? The most propitious approach could be to develop a critique of the recent wave of non-for-profit model, focusing on the accountability gap that lies at their very heart. At the very least this would help to guard against potential contamination of the mutual brand...’ (Social Market Foundation)

# Conclusions

- To work, mutuality depends on the careful balancing of divergent interests: savers and borrowers; different categories of policy-holders
- Mutuality is most successful when it remains small scale, locally-embedded or operates on the basis of a ‘common bond’
- Over time larger-scale mutuals, financial or otherwise, tend to evolve into ‘non-profit’ forms, giving rise to an ‘accountability gap’
- Mutuals are effective at delivering long-term returns in a low-risk setting but less effective at innovation; therefore society requires a mix of mutual and commercial forms
- The ‘new mutuality’ in the public sector lacks, so far, a viable legal and organisational form, and risks re-creating the ‘accountability gap’ in a new context