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Original Citation

Cork, Judith and Summers, Eric (2010) Risk in Recovery: Views of Non Executive Directors of UK Building Societies. In: BSA Established Directors Seminar Conference, Dec 7th 2010, London. (Unpublished)

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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



*A research report from the
Financial Ethics and Governance Research Group,
University of Huddersfield
November 2010*

By Judith Cork & Eric Summers



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Financial Crisis

- Financial crisis: worldwide, wide ranging impact on the wider financial service sector in the UK
- Irony of demutualised institutions being at forefront → none of the demutualised building societies exist as independent bodies
- High profile collapse of former building societies, now banks, such as Northern Rock and the Halifax Bank of Scotland (HBOS)

Northern Rock has been one of the fastest growing British banks. But it's now become the first bank in years to seek emergency funding from the Bank of England in its role as 'lender of last resort' [BBC Business News Sept 2007]

But building societies not without problems or pressures (Dunfermline, West Bromwich, Barnsley...)



Why did it happen?

2 key themes in relation to risk:

- Increased risk and complexity within the banking sector with a widespread, but often misguided belief that risk was being dispersed and ‘managed’;
- A financial sector demonstrating significantly increased leverage, with those demonstrating the most rapid growth through leverage being amongst the heaviest casualties

Government & Regulatory response



Key Reviews:

- **Turner Review** from Financial Services Authority (March 2009): 'A regulatory response to the global banking crisis'
- **Walker Review** from HM Treasury (July 2009): 'A review of corporate governance in UK banks and other financial industry entities'
- ➔ The concern has been that at the centre of the banking crisis was a mismanagement of risk; and at the centre of the management of risk is the board, and more particularly the NED. So:
- ➔ Proposes a shift in the governing role of non-executives, supporting greater challenge from a more professionalised body of Non Executive Directors (NEDs).

Purpose of FEGRReG research



Concerned with:

1. An interest in trying to establish how building society boards are currently viewing risk;
2. How the recent financial crisis has affected their risk perception, risk appetite and risk management;

both taken from the perspective of NEDs – they are seen to have a change of focus and changing expectations of their influence in controlling and directing financial institutions - in this case, building societies.

Summary findings - Walker Review



- A need for proportionality in relation to the operational context and requirements of Building Societies, especially the smaller ones;
- A concern of over-emphasising the financial background of NEDs when NEDs identified a continuing need for board diversity;
- The key remains the human element and how boards work together.

Summary views – Governance

- Support for unitary board model
- Greater focus on induction and training for NEDs
- NEDs more confident in their individual and collective abilities.

BUT

- More work in developing understanding of NED role beyond the board
- NEDs emphasise their dual role as both ‘watchdog’ and strategists
- Role ever more onerous - further challenges for future recruitment
- Wary of ‘incorporation’ and loss of ‘independence’
- Scope for use of further external, independent advice

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Summary findings - Risk



- Better informed and equipped to assess/manage risk in a focused and systematic way
- Limited adoption of some of the organisational changes (Chief Risk Officer; Board Risk Committee) – less relevant and/or financially challenging especially
- Executive remuneration seen as an exaggerated concern in the sector.
- Indications of a risk-averse sector, becoming more ingrained as an expression of internal policy intent

BUT what about the 'up-side' of risk?

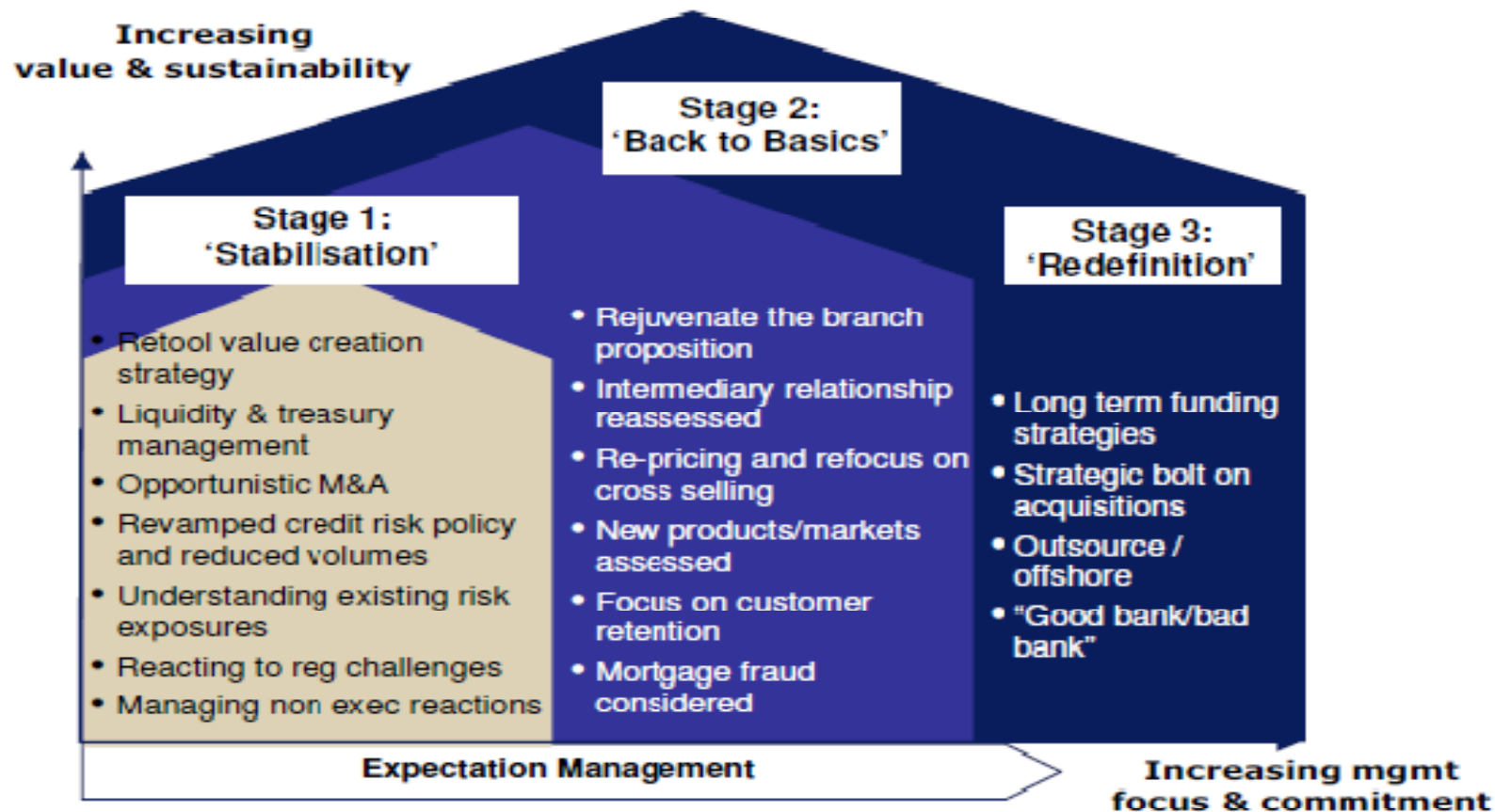
Summary views – Competitive Environment



The current status is pre-dominantly one of *'weathering the storm'*.

A continuing challenge for NEDs is in promoting entrepreneurial activity and encouraging the pursuit of (appropriate) opportunities.

Projected Business Environment (Deloitte 2009)



The challenge for the sector



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 was one of gradual marginalisation against a range of aggressive competitors in the financial sector.

The classic Porter challenge?



A niche position is OK for a smaller societies?

But will the medium and larger organisations be “stuck in the middle” – too small for cost advantage but too large and remote from their mutual origins to effectively differentiate themselves?

And then there may be other potential challenges on the horizon

A Snow White & Seven Dwarfs scenario?



Plus ... Yorkshire, Coventry, Skipton, Leeds, West Bromwich, Principality, Newcastle?

Or some new mergers yet to take place?



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The 'dividend of mutuality'?



'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.' [Kay J (1991), 'The Economics of Mutuality', Annals of Public and Co-operative Economics, Vol 62 (3) pp. 309-318.]

What does this mean in practice?

*Democratic Engagement with Members?
Keener Pricing Policies (without shareholder dividend)?
Member Friendly Practices?
Longer Term Policies and Commitments?
Mutual Culture?*

The 'dividend of mutuality'?

'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.'

'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'

'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.'

The feelings mutual?



'It seems to me that the Post Office is ideally suited to a John Lewis or Co-operative Group style structure – where employees, sub postmasters and communities get a greater say in how the company is run. This would be the Big Society in action.' **Business Secretary Vince Cable Oct 13 2010**

The feelings mutual? (even more?)



Converting failed financial institutions into mutual organisations



A Report from The Oxford Centre for Mutual & Employee-owned Business
Kellogg College, University of Oxford

Published for The Building Societies Association

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September 2009

Key questions for NEDs & Board (1)



- Have you envisioned different business models for the future to ensure survival?
- 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?
- Do you have a predominant focus on financial risk and is the cautious culture inhibiting growth unnecessarily?
- Do you have succession plans that reflect the need for a diverse board that reflects all stakeholders and areas of risk?

-

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Key questions for NEDs & Board (2)



- Do you remunerate adequately to reflect the change in responsibility and time commitments for NEDs?
- 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