The remutualisation of Northern Rock

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1. The case for remutualising

In the wake of the banking crisis, the Government's 2008 White Paper to reinvigorate competition in the banking sector included the following objective: 'supporting competition and choice through diversity, most importantly through maintaining a strong mutually-owned financial sector'. The White Paper went on to argue that:

> 'Another way of encouraging choice and competition is to encourage and support alternative business models. The Government has a long-standing aim of supporting the UK mutual sector.'

The discussion of mutuals in the Treasury White Paper emphasised the importance of competition in the financial system and the role that building societies might have. The coalition agreement pledged:

> 'We will bring forward detailed proposals to foster diversity in financial services, promote mutuals and create a more competitive banking industry.'

All this reflects a consensus across the major political parties for promoting diversity of corporate form within financial services, including a strengthened mutual sector. The case for remutualising NR (rather than selling it in a trade sale) derives both from the advantages of diversity in the financial sector and its contribution to enhancing the critical mass of the mutual sector. In this context, there are two key reasons for creating an enhanced role for mutual building societies:

i. The advantage to be gained through enhancing the mix of institutions with different portfolio structures with the potential to reduce overall systemic risk because institutions are not homogeneous. A pluralistic approach to ownership and business models is conducive to greater financial stability. The more diversified is a financial system in terms of size, ownership, and business models, the better it is able to weather the strains produced by the normal business cycle. As argued by Andrew Haldane of the Bank of

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England, a mixed system of different corporate structures is likely to produce a more stable financial system.

ii. A stronger mutual sector would enhance competition because mutuals adopt a different business model compared with banks. Whilst only ten of the 89 Societies that existed in 1992 de-mutualised, because they were amongst the largest, they represented around 70% of the sector's assets.

A particularly effective way to enhance the critical mass of mutuals would be to remutualise NR. This would pose logistical challenges bearing in mind that NR has a formal commitment to repay Government loans of £14.5 billion. The logistics have been considered elsewhere by the authors.[4] A trade sale would generate cash more quickly than would a remutualisation. The question arises, therefore, as to why the government should support a remutualisation if it would mean that the capital provided by the tax-payer might not be fully repaid in cash terms, though we argue it would be in economic terms.

The remutualisation of NR would enhance the competitive pressure on banks and create a more diversified financial services sector. Such systemic advantages, which would accrue to the population at large, would be worth paying for in terms of the tax-payer deferring the cashing-in of its investment in NR. While the remutualisation option would provide less cash up-front in the short term, a remutualisation of NR would contribute to a more durable and sustainable business which would therefore be in a position not only to make repayments over time, but also to contribute positively to the UK economy in terms of enhanced competition in the financial system. The government needs to take account not only of cash returned to the tax-payer, but also the advantages of a more diversified and competitive financial sector. If there is a trade-off between an immediate cash repayment and wider systemic benefits through the benefits of an enhanced mutual sector, the tax-payer has a legitimate interest in the project. The systemic and competitive benefits of remutualisation would likely outweigh any cash benefit to be derived from a quick sale of the Government's capital holding in NR.

In addition to the arguments outlined above, a remutualisation would also counter the further concentration and loss of competition likely to result from a trade sale. It would make a strong statement that the Government intends to support mutuality and diversity in the financial sector.

Given the systemic advantages of a mixed financial structure, there is a powerful *systemic* interest in sustaining a strong mutual sector and, therefore, it is a significant public policy issue.

We are not here making the case for any intrinsic merit of mutuals: it is a question of the advantages of diversity and the critical mass of different business models. Given the systemic advantages of a mixed financial structure, there are economic and welfare benefits to be derived from the continuation of a viable and successful

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[4] *Converting Failed Financial Institutions into Mutual Organisations*, by Jonathan Michie and David Llewellyn, University of Oxford, 2009.

mutual building society sector. A financial system populated by a diversity of ownership structures and business models is likely to be concomitantly more competitive and systemically less risky.

2. Creating an asset-lock

Thus, the banking crisis highlighted the importance to the UK economy of retaining diverse models of financial service providers. Mutuals, though affected by the downturn, proved more stable than proprietary banks. Given the barriers to entry to setting up a new mutual of any size in the deposit-taking sphere, it makes sense to explore the remutualising of a mature ex-mutual business, as well as conserving remaining mutuals. Clearly, the disposal of Government owned banks is key to ensuring a stable and competitively diverse financial services sector. It presents Government with an almost unique opportunity to influence the future direction of the industry towards more stable providers. Michie and Llewellyn (2009) argue that the Government and the UK economy would benefit significantly from transferring the Northern Rock business to a new mutual society, and that such a transaction would:

i. Create a stable financial services provider, constrained from repeating its previous mistakes.

ii. Be achieved at relatively little net cost to HM Treasury, and may even give a superior return in the long run.

iii. Counter the further concentration and loss of competition likely to result from a trade sale.

iv. Avoid the political risk of selling the holdings into a depressed market, and appearing to lose value for the taxpayer.

v. Make a strong statement that the Government intends to support responsible financial institutions.

vi. Support the promotion of diversity in financial institutions.

vii. Secure the future value of the business for the public benefit.

Under such a remutualisation, the Government's senior debt and any other capital holdings could be repaid over time under any ownership scenario, therefore the main financial issue is realising the equity value of Northern Rock for the taxpayer. It is unclear how much this value is, but an early trade sale, at today's prices and with a reported £200 million discount, may prove a poor bargain.

A new mutual could either repay the value of this equity to the Government in cash over a fixed period, or offer a reliable perpetual income stream whose net present value could match or even exceed the current equity value.

Other institutional investors could be considered, through a range of capital instruments, as part of the wider mutual.

The new mutual could be either a building society or another type of financial mutual. Crucially, the new mutual should have an asset lock that ensured members only benefitted from their ongoing financial relationship with the business. They would have no right to the underlying assets of the mutuals as these would, in effect, be held ‘in trust’ for the use of future members and for the wider public benefit.

This asset lock could be achieved under existing legislation and charitable assignment practices common in other mutuals.

One way of achieving this could be to replicate the broad structure of ownership as exists for the Co-operative Bank plc, replacing the holding parent co-operative with a similar mutual constituted as an asset locked community benefit society (legally an industrial & provident society) and holding Northern Rock plc as a subsidiary of this body.

There are several options for how membership could be offered; it could be held by existing and new customers of Northern Rock, as long as they remain members trading with the mutual. Crucially, it would be clear up front that it did not confer an individual proprietary stake in the business: and the underlying assets could not be demutualised. So members would have no incentive other than to see the business stick to its core activities.

The Oxford University Report on Corporate Diversity of 2010 again supported this option:

> ‘Keeping a reformed Northern Rock independent of the big banks will be good for competition. Northern Rock could be converted to an asset-locked public interest mutual. As a mutual committed to its core business, a remutualised Northern Rock would help the Government by supporting competition and diversity through the maintenance of a strong mutually-owned financial sector.
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> In any exit process the Government needs to realise the optimum value for the taxpayer. A re-launched and remutualised Northern Rock can pay for the taxpayer stake over time. A deferred payment profile can give the optimum outcome, both returning the full value to the taxpayer but also achieving other public policy goals.’

3. Completing the transfer

There are three objectives, set as principles for the return of Northern Rock to the private sector:

First: To maintain Northern Rock as an independent entity to aid diversity for consumers, or dispose of it to an existing mutual:

- To avoid a repeat of the circumstances that led to the Government's initial bail out; and
- To increase competition and choice for consumers;

Second: To ensure that its assets are not stripped from the business as a result of either its sale or restructuring; and

Third: To return the maximum value for the business to the Government:

- Immediate cash will be returned to the exchequer; and
- Reduce the risk of a second bail out.

All options need to be examined against these principles.

4. Steps to remutualising NR and returning value to the taxpayer:

i. Northern Rock Mutual Society (NRMS) is established as an asset-locked community benefit society;

ii. All customers of Northern Rock receive non-beneficial membership of NRMS;

iii. Northern Rock plc is transferred to sit as a subsidiary of NRMS;

iv. Northern Rock plc issues subordinated debt and pays the Government;

v. Annual payments are made to purchase shares from the Government;

vi. Annual dividends are paid to the Government on its remaining shares;

vii. Further tranches of subordinated debt can be sold as profitability increases; and

viii. Government retains an ownership stake in Northern Rock plc until agreed value has been returned.