Cass Business School
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Report for:

The Building Societies Association

An Analysis of the Relative Performance of UK Banks and Building Societies

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Research objectives

- To evaluate the relative performance of UK building societies
- To compare the performance of building societies to that of commercial banks
- To understand the impact of the financial crisis and subsequent regulatory changes on UK building societies
- To offer an evaluation of the economic outlook for the UK's building societies' sector

EXECTUTIVE SUMMARY

This report examines the performance of UK building societies since the large-scale demutualisation process ended in the year 2000. It considers the strengths and the weaknesses of the building society sector and their contribution to the financial industry, at a time where public confidence in the financial system and, in particular banks, is low. The financial services industry is undergoing a period of deep transformation, which affects all industry participants. Regulatory pressure on the sector remains intense and continues to drive further changes. Under the Vickers' reforms, High Street banks with more than £25 billion in core deposits from individuals and small businesses will be required to establish a boundary around their retail operations, resulting in an operationally distinct entity. While there is still a number of grey areas regarding the final requirements, it is expected that the ring-fencing will profoundly change the affected banking groups and will bring about structural changes in the UK banking and financial sector.

While it is generally accepted that co-operative and mutual financial institutions have weathered the crisis much better than their shareholder-oriented counterparts, they will nonetheless be confronted with a wide array of far-reaching regulatory and policy measures to reduce the risk of future financial crises, despite their recent good performance.

The results of our analysis highlight the substantial impact of the financial crisis on the sector. Return on Equity and Return on Assets decreased for both groups in the wake of the financial turmoil, with 2008 and 2009 being particularly difficult years. However, as the UK economy shows signs of recovery, the outlook is positive for both groups: banks and building societies have recovered some profitability, although not at the pre-crisis level. Asset and loan growth are mildly positive and the entry of new competitors seems to have had an encouraging effect on activity. Capitalisation ratios are above the regulatory guidelines and both groups are currently in a position to meet the regulatory minimum leverage ratio.

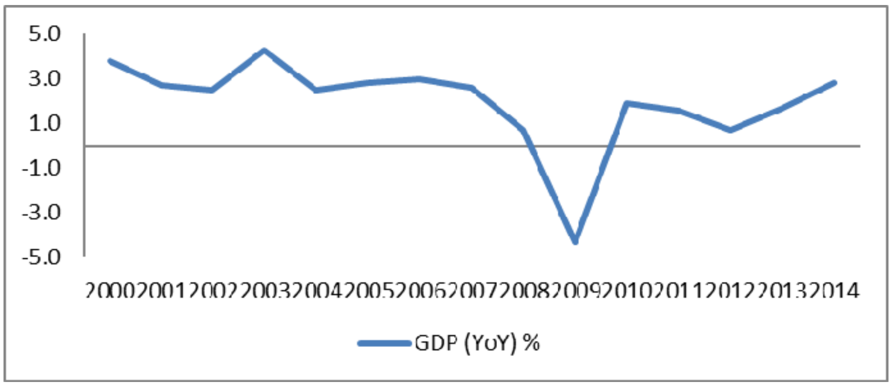
Building societies in particular have recovered well from the financial turmoil and they appear less risky than banks on a variety of measures, from lower volatility of earnings, lower volatility of NIMs and higher z-scores.

1. BACKGROUND

1.1 The UK Economic Outlook

After more than a decade and a half of steady growth, the UK economy was officially declared to be in a recession in January 2009. The recession was a consequence of the credit crunch that began in the USA in August 2007 and which resulted in a global financial crisis in the autumn of 2008. It is now more than seven years since Lehman Brothers collapsed, ushering in the worst phase of the financial crisis, and the UK economy has been recovering at a relatively strong rate since early 2013.

Figure 1. GDP Growth (%) Year on Year



Source: Office for National Statistics (ONS) and author's calculations

In 2014, the UK economy grew by 3.0%, the fastest rate since 2007 and the strongest growth rate in the G7 group of countries (Office for National Statistics). UK growth has been driven primarily by services and is projected to continue at a solid pace in 2015 and 2016, boosted by domestic demand (Institute for Fiscal Studies). There are still, however, causes for concern. For example, while the household debt-to-income ratio has fallen over the last three years, it remains around 150%, significantly higher than those of other European countries and the US.

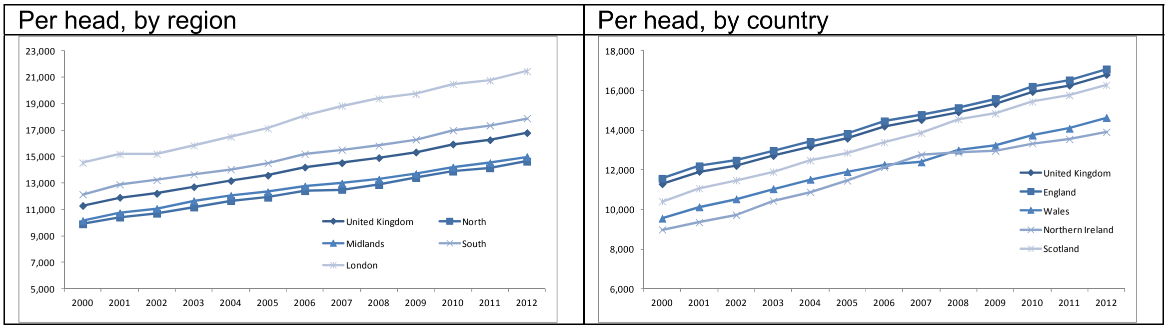
Table 1: Economic Indicators

	Economic Growth (YoY, %)	Inflation (YoY, %)			Household Income		
	GDP	*CPI*	*RPIX*	*RPI*	*Real household disposable income (YoY, %)*	*Saving Ratio %*	*Household debt to income ratio %*
2000	3.8	0.8	2.1	3	6.5	9.8	112
2001	2.7	1.2	2.1	1.8	4.9	10.7	119
2002	2.5	1.3	2.2	1.7	2.7	9.9	130
2003	4.3	1.4	2.8	2.9	2.7	9.2	141
2004	2.5	1.3	2.2	3	1.2	7.7	152
2005	2.8	2.1	2.3	2.8	2.1	7	154
2006	3	2.3	2.9	3.2	1.8	6.5	164
2007	2.6	2.3	3.2	4.3	2.4	7.1	168
2008	0.7	3.6	4.3	4	-0.6	5.6	167
2009	-4.3	2.2	2	-0.5	2.3	9.3	159
2010	1.9	3.3	4.8	4.6	0.9	11	151
2011	1.6	4.5	5.3	5.2	-1.9	8.6	150
2012	0.7	2.8	3.2	3.2	1.6	8	147
2013	1.7	2.6	3.1	3	-0.2	6.4	147
2014	3.0	1.5	2.4	2.4	1.5	6.0	144

Source: ONS, Bank of England and author’s calculations. YoY = Year on Year.

After several false starts following the financial crisis, the UK economy seems to be enjoying a period of sustained strong growth, helped by low oil prices, low inflation boosting purchasing power and low interest rates fostering investment. Growth has been particularly strong in London and in the South East, although there are signs of recovery in the rest of the country. UK employment has risen in recent years and has supported consumer spending. It is expected that the low cost of finance will help maintain domestic demand growth.

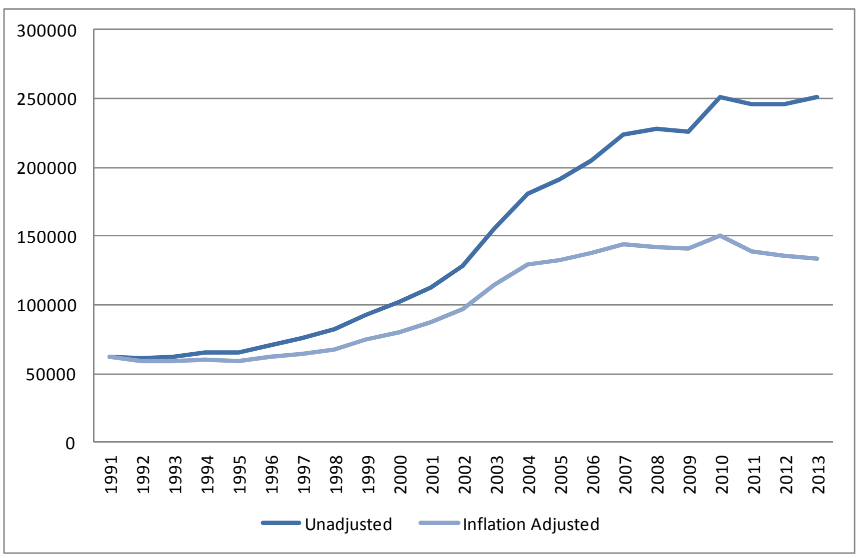
Figure 2. UK Gross Disposable Household Income (by region and by country)



Source: Office for National Statistics (ONS) and author's calculations.

Rising house prices have also supported consumer confidence and spending. House prices increased by approximately 10% in 2014, which was the strongest annual average performance since 2007. However, there were signs of the housing market cooling down in late 2014 (PwC, 2015).

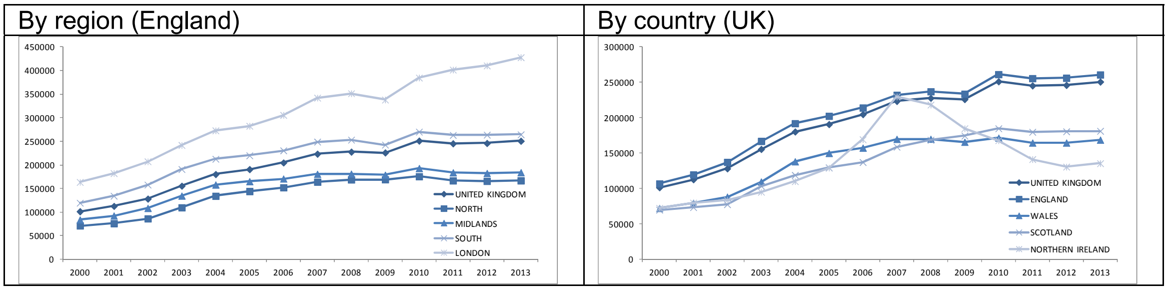
Figure 3. UK Average House Prices



Source: Office for National Statistics (ONS) and author's calculations.

There are marked regional differences in the UK housing market, reflecting differences in income per capita, employment and economic growth. Once again, London and the South East display higher house price growth compared to the rest of the UK. The average London home now costs around £500,000 according to the ONS. Excluding London and the South East, house prices increased by 7.4% in 2014.

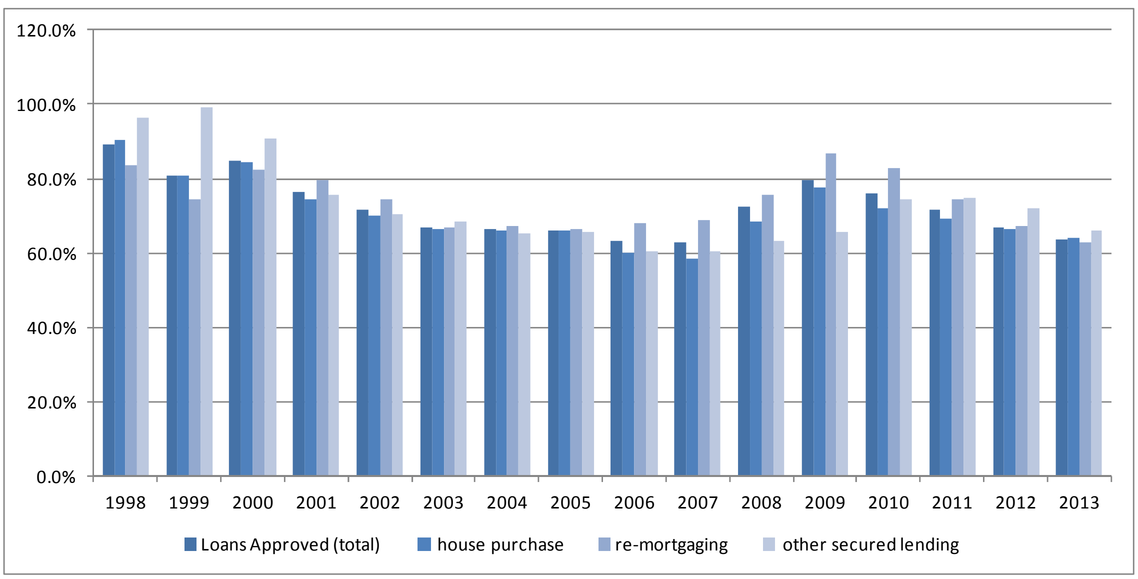
Figure 4. UK Average House Prices (by region and by country)



Source: Office for National Statistics (ONS) and author's calculations.

The buoyant housing market has also been reflected in an increase in banks' real estate lending: after a decrease in the mid-2000s, the share of new lending approvals by High Street banks has increased in recent years. This increase in banks' market share is largely due to a reduction in the share of specialist lenders, resulting from their difficulty in raising wholesale funding – particularly via securitisation - since 2009.

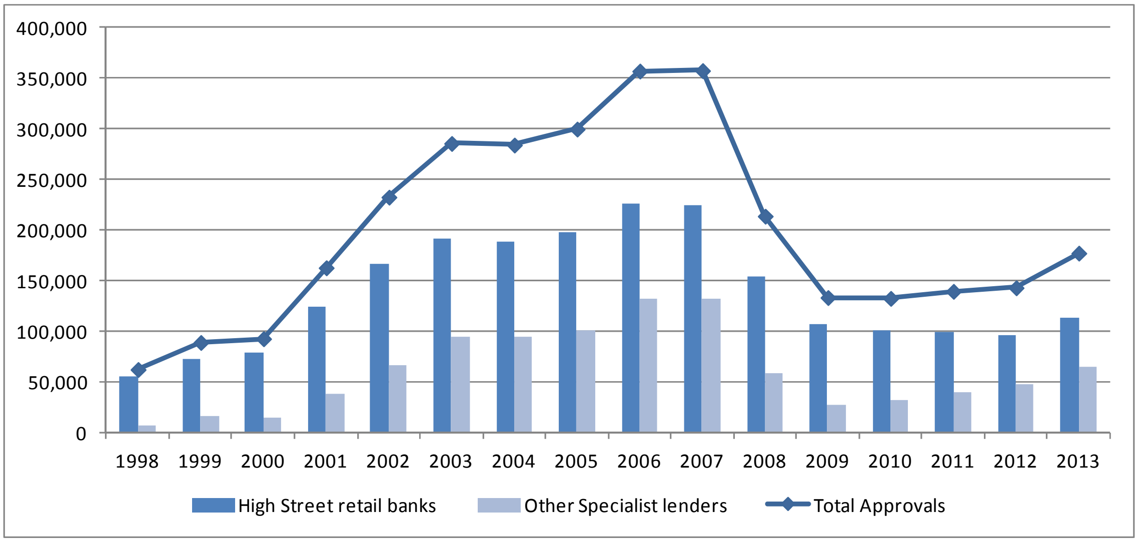
Figure 5. High Street Banks share of new lending approvals (%)



Source: British Bankers Association (BBA) and author's calculations. High street banks were previously named MBBG – Major British Banking Groups.

While house prices have continued to increase in most regions of the UK (see Figure 4), household income has not followed suit. In some regions, activity in the housing market has been slow over the past few years, with Northern Ireland being badly hit by the crisis. Both house prices/earnings and mortgage/earnings ratios have increased since 2008, making houses less affordable particularly in London and the South of England and for first time buyers. However, as credit conditions begin to loosen and mortgage availability improves, housing activity could be picking up pace compared to the past five years. This should be felt mostly at the lower end of the housing market which has been particularly constrained in recent years as banks have been more careful lenders, demanding lower loan-to- value ratios and lower income multiples.

Figure 6 Sterling Mortgage Lending - Approvals (£ million)



Source: British Bankers Association (BBA) and author's calculations.

Although the UK economy is showing signs of recovery, the recession triggered by the global financial crisis had serious repercussion in many areas. This has important implications for firms' performance, as differences tend to increase significantly in recessions. While the average profitability across firms follows the path of the business cycle, the variation in profitability across firms rises sharply in a downturn.

It is against this background that the remainder of this report will focus on the performance of UK banks and building societies over the past 15 years, a period that covers both the pre-crisis boom, the crisis, the ensuing recession period and the recent recovery period. This will enable us to assess how different financial institutions, including shareholder-oriented commercial banks and stakeholder-oriented building societies have performed under different economic conditions.

2. AN OVERVIEW OF THE STRUCTURE OF THE UK BANKING SECTOR

2.1 The Global Financial Crisis and Structural Reforms

UK banking was hit dramatically by the global financial crisis. A once profitable, innovative and dynamic industry virtually collapsed, exposing a series of weaknesses that increased the severity of the crisis and its impact on the UK's economy.

The rapid growth of the financial sector, particularly in terms of the relative size of wholesale financial services within the overall economy, accompanied by an increase in leverage (asset to capital) and with an increase in the complexity of the financial system, are considered some of the key causes of the crisis. In addition, the growing scale of banking activities coincided with changing forms of maturity transformation, which led to an underestimation of risk. As a leading financial centre, the UK was greatly exposed to these factors, which played a crucial role in reinforcing the severity of the financial crisis.

The decade prior to the onset of the global financial crisis saw major changes in the way banks conduct their business, with many financial institutions extending beyond the conventional intermediating role. This entailed a change in banks' business models, which fuelled banking sector growth and risk-taking. The failure of some of these banks in the late 2000s exposed the limitations of these business models and spurred fundamental changes in regulation and supervision.

However, not all types of banks followed the same path to balance sheet expansion and increased risk-taking and were therefore not affected in the same way by the crisis. Nevertheless, all types of banks and financial institutions are facing the new challenges and responding to the changes in the regulatory structure.

The events of 2007-2009 also revealed the weaknesses of the existing regulatory system and set the agenda for regulatory reform. The 2012 Financial Services Act abolished the existing financial regulator, the Financial Services Authority and created three new regulatory bodies: the Financial Policy Committee (FPC), the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA). Two of the three new bodies, the FPC and the PRA are subsidiaries of the Bank of England; while the FCA is a separate body responsible for business, consumer protection and market conduct. In addition, the 2013 Banking Reform Act introduced the most significant reform of the UK banking sector in a generation, largely based on the recommendations of the Independent Commission on Banking (ICB), which reported in September 2011 (also known as the

Vickers Report). The 2013 Banking Reform Act will bring into law structural and cultural changes to the banking system, by: (i) introducing a ‘ring-fence’ around the deposits of people and small businesses, to separate the high street from the trading floor and protect taxpayers when things go wrong (by 2019). This will require the largest UK banks to carry out wide reaching re-organisations of their businesses; (ii) making sure the new PRA can hold banks to account for the way they separate their retail and investment activities, giving it powers to enforce the full separation of individual banks; (iii) imposing higher standards of conduct on the banking industry by introducing a criminal sanction for reckless misconduct that leads to bank failure; the penalties for which can include an unlimited fine and a custodial sentence of up to 7 years; (iv) giving depositors, protected under the Financial Services Compensation Scheme (FSCS), preference if a bank fails; (v) giving the government power to ensure that banks are more able to absorb losses and (vi) introducing a cap on payday loans. The provisions in the Act are due to come in to force on various dates between now and 1 January 2019. These reforms are far reaching and will lead to the creation of a new financial landscape. Banking groups will be broken up into retail and wholesale/investment banking entities. These changes will affect all deposit-taking institutions, save for the smallest of them. Reforms are therefore expected to affect both the Major British Banking Groups (MBBGs) and the Building Societies sector.

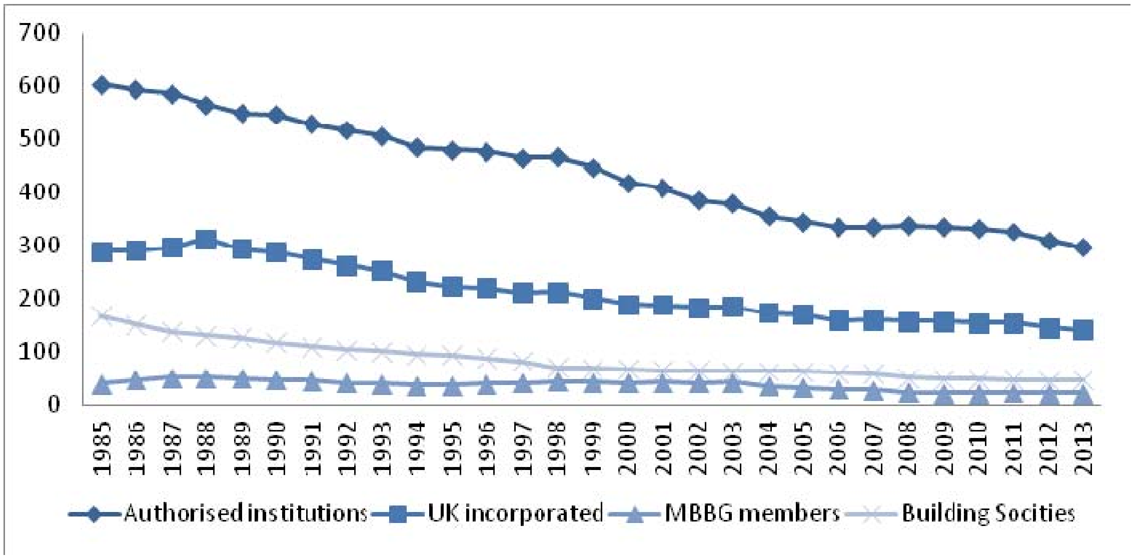
While the focus of the analysis so far has been on the recent regulatory reforms, it is important to recall that the current structure of the UK banking sector has been shaped by earlier reforms. To understand the on-going changes brought on by the global financial crisis, it is necessary to step a little further back in time and discuss the changes that shaped the UK financial sector from the 1980s to the mid-2000s. A number of regulatory changes, known as the Big Bang, have reduced demarcation lines between different types of financial service firms, especially between banks and building societies, as well as commercial and investment banking business. Under the 1986 Building Societies Act, building societies were given the option to convert to PLC (and bank) status. In 1989, Abbey National was the first building society to exercise the option and convert to a bank.

Changes governing the regulatory treatment of the building society sector have had a major impact on the competitive environment in the retail banking sector. Paradoxically, reforms that were put in place to improve the competitive stance of the mutual sector vis-à-vis commercial banks led to a systematic decline of the former. This is because most of the largest building societies embraced demutualisation, leading to a shift of assets from the mutual to commercial banking sector. Appendix 1 summaries the demutualisation of the UK building societies and charts their subsequent history up to 2015. Some commentators have branded the demutualisation as a large failure, as the demutualised building societies have played a large part in the UK banking crisis, from the failure of Northern Rock, Bradford & Bingley and Alliance & Leicester to the troubles of the Halifax. These banks had to be absorbed into mainstream banking groups at the height of the banking crisis and this led to a profound reorganisation of the banking sector (see Appendix 1).

2.2 The Structure of the UK Banking Sector

In contrast to other large European countries, the UK has a relatively small number of banks. The market is dominated by the High Street banks (also known as the Major British Banking Groups - MBBGs), which include: Santander UK; Barclays; HBOS, HSBC Bank; Lloyds TSB; The Royal Bank of Scotland, NatWest and the new entrant Virgin Money (previously Northern Rock). Appendix 2 illustrates the composition of MBBGs over time. Other UK banks include Standard Chartered; the Co-operative Bank; Yorkshire Bank and Clydesdale Bank. The total number of authorised banking institutions has fallen from around 600 in 1985 to 298 by 2013. Of these, 141 are UK incorporated; 78 are incorporated in the European Economic Area and 79 are incorporated outside the European Economic Area. The decline in the total number of banks is attributable to foreign banks acquiring UK banks as well as consolidation in the domestic retail banking market, following the demutualisation of building societies in the 1990s.

Figure 7. Number of banks and building societies (1985-2013)



Source: British Bankers Association (BBA) and author's calculations. Major British Banking Groups (MBBGs) in 2000 included the following: Abbey National Group, Alliance & Leicester Group, Barclays Group, Bradford and Bingley plc (from 2000), The HBOS Group, HSBC Bank Group, Lloyds TSB Group, Northern Rock Group (from 1999) and the Royal Bank of Scotland Group. In 2013 they comprised: Santander UK Group; Barclays Group; HSBC Banking Group; the Lloyds Banking Group; The Royal Bank of Scotland Group.

Up until the end of 2007 the MBBG included: Abbey National, Alliance & Leicester, Barclays, Bradford & Bingley, HBOS, HSBC Bank, Lloyds TSB, Northern Rock, and the Royal Bank of Scotland. Four of these were mutual building societies that converted to bank status – Abbey National (converted in 1989), Alliance and Leicester (1997), Northern Rock (1997) and Bradford & Bingley (2000). HBOS was formed by the merger of Halifax (that converted into plc and bank status in June 1997) and the Bank of Scotland in September 2001.

Since mid-2007 the MBBGs have experienced turmoil and there have been significant developments adversely affecting their activities. Northern Rock was the first casualty of the crisis in September 2007. Later the same month Lloyds TSB announced that it was to acquire HBOS for £12bn, creating a merged entity with a market share of around one-third in the UK savings and mortgage markets. In September 2008 the UK government also announced the acquisition of the mortgage-lending arm of Bradford and Bingley, and selling the still-viable depositor base and branch network to the Spanish Santander banking group. In October 2008, capital injections were announced for RBS and Lloyds TSB and HBOS, thus increasing the government stakes in their ownership to around 60% and 40%, respectively. In November 2008, the UK government set-up a new 'arms-length' company, UK Financial Investments Ltd (UKFI), to manage the banks in public ownership, Northern Rock and Bradford and Bingley. In 2013 Cheltenham & Gloucester branches and accounts were transferred to TSB, within the Lloyds Banking Group. TSB was revived, as a separate brand, after the EU demanded Lloyds Banking Group spin off 631 branches as a condition of its bailout in 2008. TSB has been sold to Spanish bank Sabadel in 2015.

The British Bankers' Association (2012) has changed the definition of Major British Banking Groups (MBBG) to "*the main high street banking groups*". By 2015, the term refers to the UK activity of 21 institutions across the following banking groups: Barclays, HSBC Bank, Lloyds Banking Group, Royal Bank of Scotland Group, Santander UK and Virgin Money.

A large-scale consolidation process has occurred in the building societies sector. There were over 2,000 at the beginning of the 20th century in 1900, but today they are a movement dominated by the larger societies. Recent figures show the steady decline in the number of mutual building societies, particularly in the post crisis period. Building societies numbers fell from 55 in 2008 to 44 in 2014. The key merger and acquisition (M&A) operations are the acquisition of the Britannia Building Society by the Co-operative Bank in 2009. In the same year, the merger between the Yorkshire Building Society and Chelsea Building Society; between Skipton and Scarborough Building Societies and between Coventry and Stroud and Swindon Building Societies. Notably, Nationwide acquired the troubled Dunfermline Building Society in 2009. The sector has seen some further consolidation, with three mergers between 2013 and 2014.[1]

Nationwide is by far the largest, with group assets over £195 billion at the end of 2014, followed by the Yorkshire Building Society, which has £37.5 billion in assets and the Coventry Building Society with assets of £31 billion (the top five societies account for over 8o% of the sector's assets).

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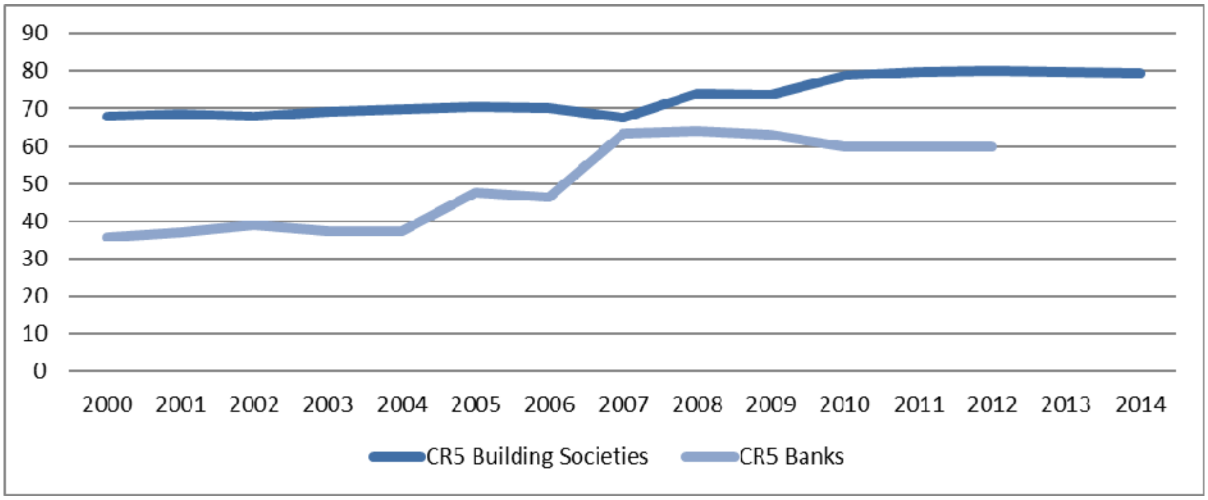
[1] On the 1 February 2013 Century Building Society merged with Scottish Building Society. On the 1 July 2013 Shepshed Building Society merged with Nottingham Building Society. On the 1 July 2014 City of Derry Building Society merged with Progressive Building Society.

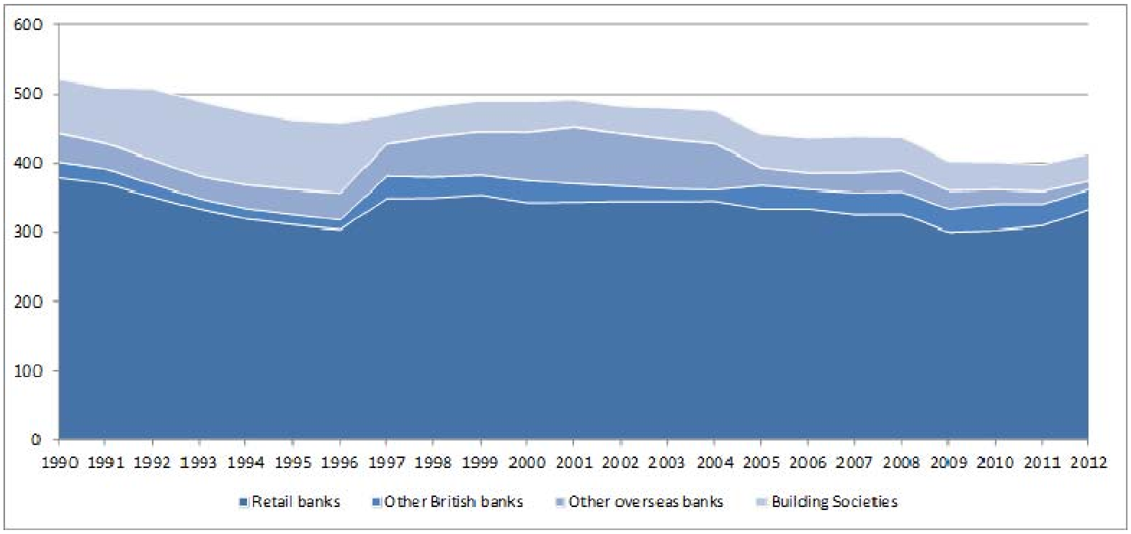
Figure 8. Concentration ratio (CR5)



Source: Source: British Bankers Association (BBA); Building Societies Association (BSA) and author's calculations. Note the Building Societies CR5 is calculated as the sum of total assets of the 5 largest building societies over the total building societies' sector assets; the CR5 for banks is calculates as the sum of the five largest banks over the total banking sector's assets.

The global financial crisis has also had a negative impact on UK banking sector employment: the main UK banks have shed around 25,000 staff since mid-2007 and this puts total employment down from 318,300 to 292,600 by 2012. The average staff costs accounted for 0.6% of total assets and remained at a stable proportion for the period 2009 - 2012 (British Bankers Association, 2013).

Figure 9. Employment in Banks and Building Societies



Source: British Bankers Association (BBA); Building Societies Association (BSA) and author's calculations

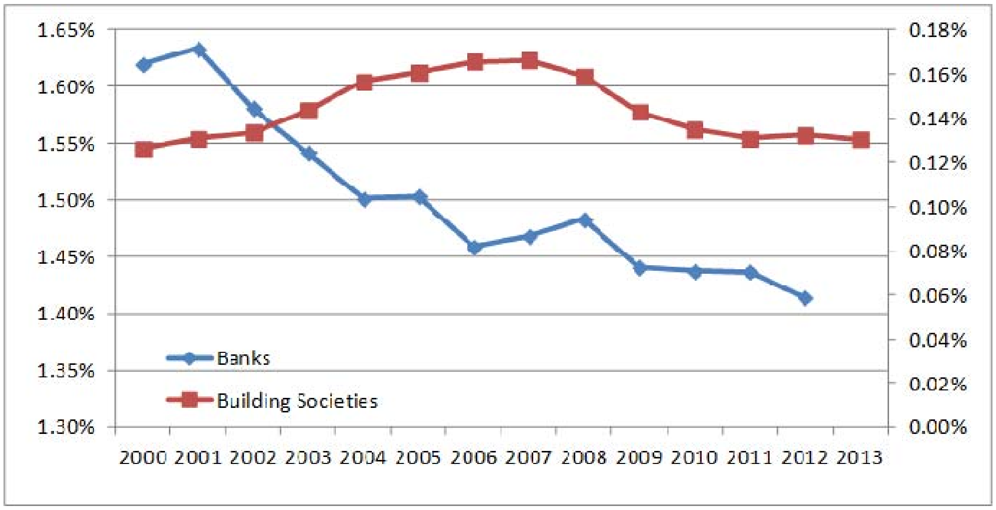
The largest employer in 2012 was Lloyds Banking Group (110,295 employees), followed by HSBC Bank (74,190 employees). The Royal Bank of Scotland was the largest employer in 2007 with 203,500 but only had 71,200 by the end of 2012. The building societies sector followed a similar trend, the total number of staff employed decreased from 48,944 in 2007 to 39,397 in 2012 (although there are signs of the trend reversing in recent years, as the total number of staff employed increased by almost a 1,000 to 40,220 by the end of 2014. The largest employer was Nationwide, which almost doubled the number of staff employed between 2000 and 2007 (from 9,741 to 16,815 in 2007), and continued to increase its workforce (it had 17, 706 by the end of 2012). Table 2 highlights the trends in employment in the banking and building societies sector between 2000 and 2012. Notably, while the largest banking groups underwent major restructuring, the largest building societies have displayed steady growth rates over the period. This trend is confirmed when considering the proportion of employment in banks and building societies, as percentage of total employment (see Figure 10).

Table 2: Total Staff – Banks and Building Societies (2000 – 2012)

			2000	*2007*	*2012*
MBBGS					
	Santander		n/a	n/a	25,800
		Abbey National	19,400	14,100	n/a
		Alliance & Leicester	9,200	8,100	
	Barclays		56,500	58,300	49,600
		Woolwich	7,700	n/a	n/a
	Bradford & Bingley		7,700	3,100	n/a
	HBOS		n/a	47,500	n/a
		Halifax	26,100	n/a	n/a
		Bank of Scotland	12,800	n/a	n/a
	HSBC Bank		48,000	49,500	43,800
	Lloyds Banking Group		n/a	n/a	96,600
	Lloyds TSB		n/a	50,600	
		Lloyds	57,400	n/a	n/a
		TSB Group	n/a	n/a	n/a
	The Royal Bank of Scotland		19,700	80,400	74,200
		National Westminster	47,500	n/a	n/a
	Northern Rock		3,100	6,700	n/a
	Virgin Money		n/a	n/a	2,600
TOTAL MBBGS			**307,300**	**318,300**	**292,600**
OTHER BANKS					
	Bristol & West		2,800	n.a.	n.a.
	Clydesdale Bank		3,600	8,850	10,400
	Yorkshire Bank		4,900	1,789	1,896
	The Co-operative Bank		4,000	4,300	7,400
BUILDING SOCIETIES					
	Nationwide		9,741	16,815	17,706
	Yorkshire		1,468	2,364	4,088
	Skipton		2,966	9,977	8,438
	Leeds		840	987	946
	Principality		588	1206	1,242
TOTAL BUILDING SOCIETIES			**34,774**	**48,955**	**39,397**

Source: British Bankers Association (BBA); Building Societies Association (BSA) and author's calculations.

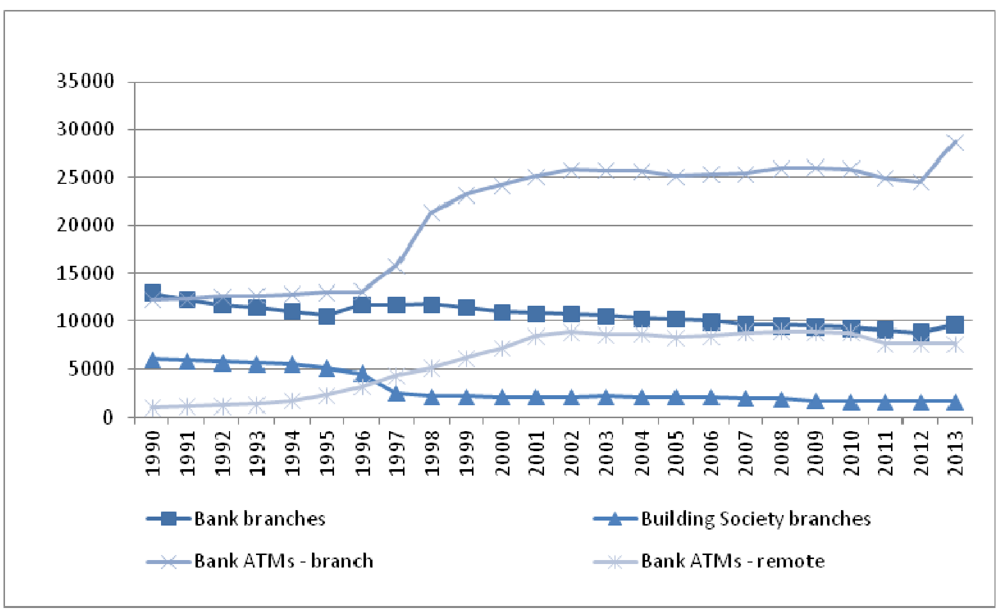
Figure 10. Employment in Banks and Building Societies (as % of Total Employment)



Source: British Bankers Association (BBA); Building Societies Association (BSA); Office for National Statistics (ONS) and author's calculations.

Notwithstanding the forced impact of the financial crisis, UK banks and building societies have engaged in significant reorganisation over the past 15 years. This is characterised by the decline in branch numbers, a trend that further accelerated post-crisis, with a fall from 10,051 in 2006 to 8,837 in 2012 (British Bankers Association, 2013).

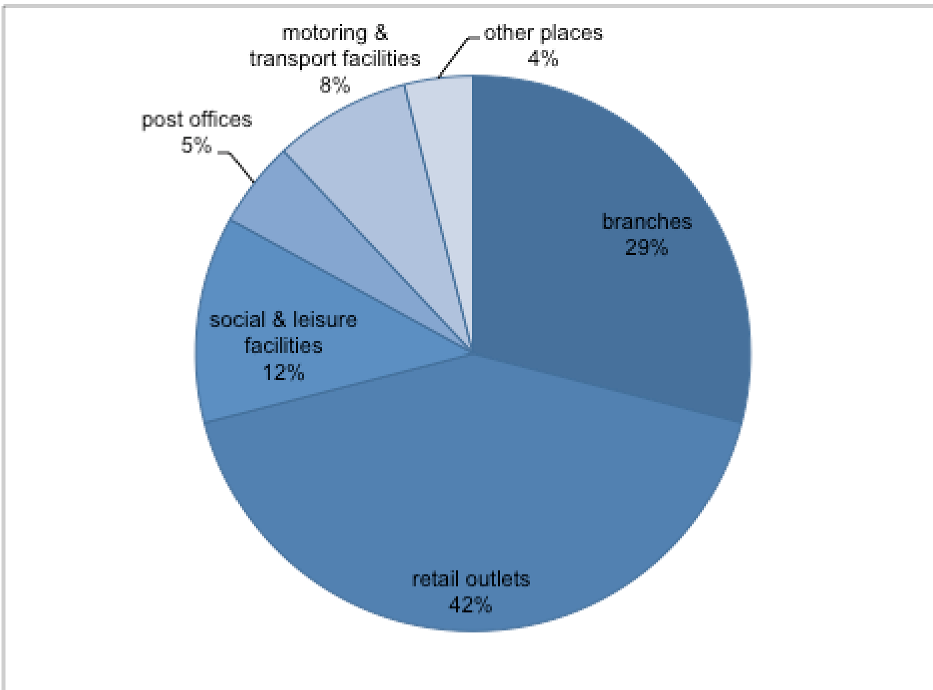
Figure 11. Branches and ATMs (1990 -2013)



Source: British Bankers Association (BBA) and author's calculations.

Figure 11 shows the trends in branch and ATM numbers in the UK since 1990 and illustrates that during the 1990s, while branch numbers were declining, the introduction of ATMs (at the branch and in 'remote' locations) grew significantly. The reason for the shift from branches to other means of financial service delivery mainly relates to UK retail financial service firms' desire to improve operating efficiency as well as customers' increasing demands to access banking services outside traditional (rather limited) banking hours. The highest number of ATMs can be found not at the branches but in retail outlets (see Figure 12).

Figure 12. ATM locations in the UK



Source: British Bankers Association (BBA) and author's calculations.

The largest branching network in 2012 was of Lloyds TSB (1,749 branches), followed by Barclays (1,593 branches). However, a ruling of the European Commission in 2009 on the conditions for state aid raised the issue of forced divestments through the sale of branches. The aim of the ruling was to increase competition and customer choice in the UK banking sector. The Co-operative Bank had agreed earlier in 2012 to buy 632 Lloyds bank branches, although the deal fell through in May 2013. In September 2013 Lloyds Banking Group announced the launch of TSB as a separate bank. The standalone TSB has a network of 631 branches in England, Wales and Scotland and was acquired by the

Spanish bank Sabadel in 2015. The decrease in branch numbers has been a trend even in the building societies sector, although the reduction has not been as marked: branch numbers fell from 2,139 in 2000 to 1,943 in 2007 to just over 1,600 by the end of 2014.

3. THE ECONOMICS OF BUILDING SOCIETIES

Co-operatives, savings and mutual financial institutions have a long history in most developed countries. These institutions, also known as stakeholder-based financial institutions, represent an important share of the banking sector in many countries. Although technically speaking, building societies in the UK are not cooperative banks (not the least because, by regulation, they are not "banks" and do not offer the full range of banking services), as mutuals they are a subset of stakeholder-based financial institutions (Ayadi et al 2010).

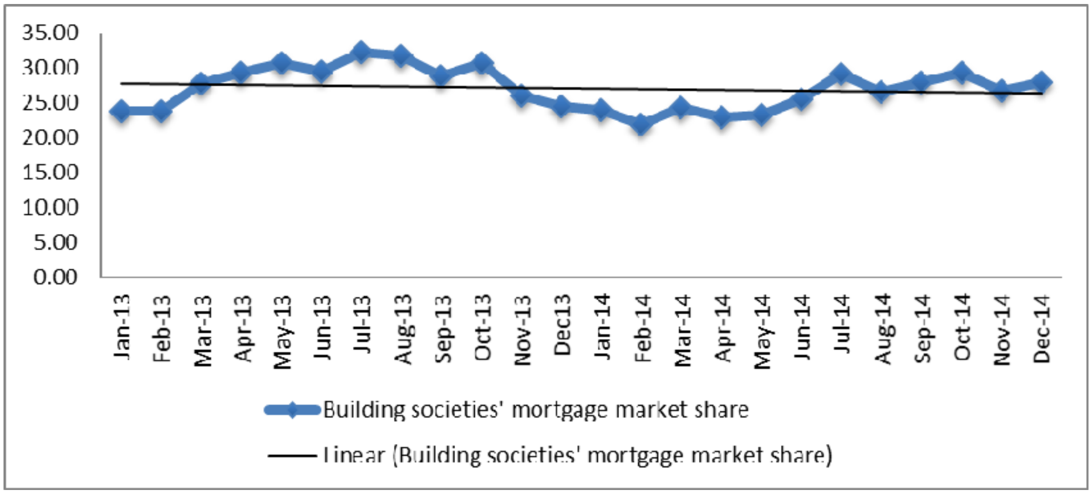
Building societies are mutual organisations, owned by their members. The UK building societies sector is regulated by The Building Societies Act 1986 and subsequent amendments.[2] The 1986 Act (Section 5(1)) provides that a building society may be established under the 1986 Act if (and only if) -

"*Its purpose or principal purpose is that of making loans which are secured on residential property and are funded substantially by its members*"

Building societies used to be focused on the real estate and housing finance. Following the deregulation in the 1980s, they became more integrated into the overall financial system although this also meant they faced increased competition from commercial banks, as the latter were increasing their share of the mortgage business. Even today, they remain highly specialised mutual institutions. UK building societies' share of the mortgage market is around 27 per cent, as illustrated by Figure 13 which reports the proportion of mortgage lending advanced by building societies over the total mortgage lending advance by all monetary financial instructions as reported by the Bank of England for the period January 2013 to December 2014.

[2] That Act has subsequently been revised by the Building Societies Act 1997, by the Financial Services and Markets Act 2000 and by the Financial Services Act 2012.

Figure 13. Building Societies' share of the UK mortgage market (Jan 2013 – Dec 2014)



Source: Bank of England (BOE); Building Societies Association (BSA) and author's calculations**.**

Although subsequent legislation have relaxed some of the constraints on building societies' permissible activities, they are still faced with some notable restrictions, including:

- the lending limit: at least 75% of the "business assets" of a building society must be loans fully secured on residential property (Section 5 of the Act).
- the funding limit: at least 50% of the funds of a building society must be raised in the form of shares held by individual members of the society (Section 6 of the Act)
- the limit of the powers a building society in relation to acting as a market maker in securities, commodities or currencies; trading in commodities or currencies; and entering into transactions involving derivatives (Section 9A of the Act).

Unlike commercial banks, ownership is not based on shareholders but on membership. As progressive liberalisation of the restrictions imposed on the activities a mutual can undertake has taken place, it is often argued that the key difference between stakeholders-based financial institutions and shareholder-oriented commercial banks lies in the objectives pursued by managers. While the key objective for commercial banks is shareholders' wealth maximisation, managers of stakeholder-based financial institutions have to fulfil different targets, ranging from providing banking services to specific geographical areas, professions or individuals with specific characteristics. However, this does not imply that managers of stakeholder-based financial institutions do not have in their remit profit generation, insofar that profit is related to the institution's solvency and growth prospects. This is also known as a "double bottom line", i.e. where profit maximisation has to be combined with social and other objectives (Anguren Martin and Marques Sevillano, 2011).

Building societies, as mutuals, cannot readily raise external capital. As a result, most of building societies' capital is retained earnings built up over time and which does not need to be remunerated. This creates both challenges and opportunities. The challenge is raising external capital: building societies have issued limited amounts of capital instruments in the past.[3] This difficulty in raising external funds makes building societies generally more risk averse and to maintain conservative capital positions. Some argue that the absence of pressure to make returns to shareholders may mean societies avoid the short-termism that shareholder-oriented institutions are sometimes accused of. Some authors (see Ayadi et al, 2009) have also argued that this characteristic might make mutuals better at mitigating risk on an inter-temporal basis, as they tend to accumulate less risk through the cycle. This is often seen as a positive contribution to the stability of the overall financial sector (Michie and Llewellyn, 2010).

Academic research indicates that during the global financial crisis, co-operative banks faired comparatively well (Hesse and Cihak; Ayadi et al., 2010; Groeneveld and de Vries, 2009). This was attributed to their business model and governance mechanisms, which follow a longer- term perspective, as they do not have to deliver short-term returns to shareholders. A recent study by Chiaramonte et al (2015) finds that co-operative banks and other mutual financial institutions contribute positively to financial stability, but only above a certain market threshold.

The contribution of co-operative and mutual institutions to financial stability, however, remains controversial. As managers are less exposed to market discipline, this could lead to high level of inefficiency in the sector. This, in turn, can have a negative

[3] Permanent Interest Bearing Shares (PIBS) were issued by a number of (mainly larger) societies, but these no longer qualify as Core Equity Tier 1 capital. A few societies have Profit Participating Deferred Shares (PPDS) as part of a capital restructuring during the crisis and these do qualify, but none of these have been issued independently. Only Nationwide Building Society has successfully developed and issued a new instrument, Core Capital Deferred Shares (CCDS), which satisfies the regulators' latest requirements to qualify as CET1 under CRDIV.

impact on innovation, on the adoption of new technology and on diversification of both funding and income sources.

In addition, some studies suggest that mutuals may find it more difficult to implement changes in response to adverse circumstances. For example, that the Swedish co-operative banking sector did not survive the crisis of the early 1990s, since it faced high marginal costs of capital. Brunner et al. (2004) note that the need to restore capital was a major factor in the decision to demutualise in the Swedish case. Mutuals may be more vulnerable to shocks in credit quality and interest rates, since they are less diversified than commercial banks (Fonteyne, 2007).

In the debate on the advantages and disadvantages of stakeholder-based financial institutions, a main argument relates to the need to foster and maintain diversity in the sector. A report prepared by Ayadi et al (2010) argues that preserving a multiplicity of aims within banking – a sort of biodiversity of banks – should be a paramount objective for policymakers. The main arguments for maintaining diversity in the financial sector include:

- improving access to financial services
- fostering regional development
- mitigating inter-temporal risks
- capitalising on the value of diversity
- stability of earnings

The remainder of this report provides an analysis of the comparative performance of UK banks and building societies after the large-scale demutualisation of the late 1990s. In carrying out the analysis, we have focused on a number of metrics, which will hopefully allow us to provide an informative picture of the strengths and weaknesses of the different business models. In reading the results of the analysis it is important to bear in mind that although they compete for customer deposits and in some of the same markets, such as the mortgage market, building societies have a very different purpose to that of shareholder-owned banks, as outlined above.

We are aware that assessing societies against standard bank performance metrics is unlikely to be appropriate and might yield a biased view of the sectors' performance. However, we believe that this analysis will be informative for policymakers when weighing up what the future shape of the banking sector should be, if it can help to demonstrate the differences between types of organisations competing in the market.

4. THE PERFORMANCE OF BUILDING SOCIETIES: A COMPARATIVE ANALYSIS

The analysis is based on the dataset described in Appendix 3, based on a sample of UK commercial banks and building societies. For the purpose of the analysis, banks were further divided into MBBG and Other Banks. Building Societies were divided into three peer groups, according to asset size. The relevant ratios are presented both for the full sample and for the subsamples. Data are collected from unconsolidated financial statements. Banking data are collected from annual balance sheet and income statements made available via the Bankscope database (Bureau van Dijk) and supplemented by information available from SNL Financial. Building societies data were made available by the Building Societies Association (BSA) for the purpose of this report.

Table 4 illustrates the descriptive statistics of our sample of banks and building societies. Banks are on average larger institutions, although differences in size among banks are bigger than among building societies. The sample is unbalanced to allow for entry, exit and mergers and acquisitions during the sample period. We include all commercial banks and building societies active in at least one year over the period 2000-2014. To this end, each institution in the sample has been examined individually, for each year it was active over the sample period.

For the identification of the Major British Banking Groups (MBBGs) we follow the definition of the British Bankers Association and incorporate the changes in the definition over time. For example, MBBGs in 2000 included the following: Abbey National Group, Alliance & Leicester Group, Barclays Group, Bradford & Bingley, the HBOS Group, HSBC Bank Group, Lloyds TSB Group, Northern Rock Group and the Royal Bank of Scotland Group. The composition of these groups has changed during the sample period, following M&As and sector restructuring. In 2014 they comprised: Santander UK Group; Barclays Group; HSBC Banking Group; the Lloyds Banking Group; The Royal Bank of Scotland Group and Virgin Money.

For the allocation of building societies in to Peer Groups, we follow the grouping of the KPMG's annual publication (KPMG Building Societies Database). The resulting groups (as of 2014) are as follows:

- **Peer Group 1 (PG1)**: Nationwide; Yorkshire; Coventry; Skipton; Leeds; Principality; West Bromwich; Newcastle; Nottingham; Progressive; Cumberland; National Counties; Saffron; Cambridge.

- **Peer Group 2 (PG2)**: Monmouthshire; Furness; leek United; Manchester; Newbury; Hinckley & Rugby; Ipswich; Darlington; Market Harborough, Melton Mowbray; Scottish; Tipton and Coseley; Marsden; Hanley Economic; Dudley.
- **Peer Group 3 (PG3)**: Mansfield; Loughborough; Bath Investment; Vernon; Harpenden; Teachers; Stafford Railway; Buckinghamshire; Swansea; Chorely & District; Beverley; Holmesdale; Ecology; Earl Shilton; Shepshed; Penrith.

Table 4 Descriptive statistics - banks and building societies (averages in £ million)

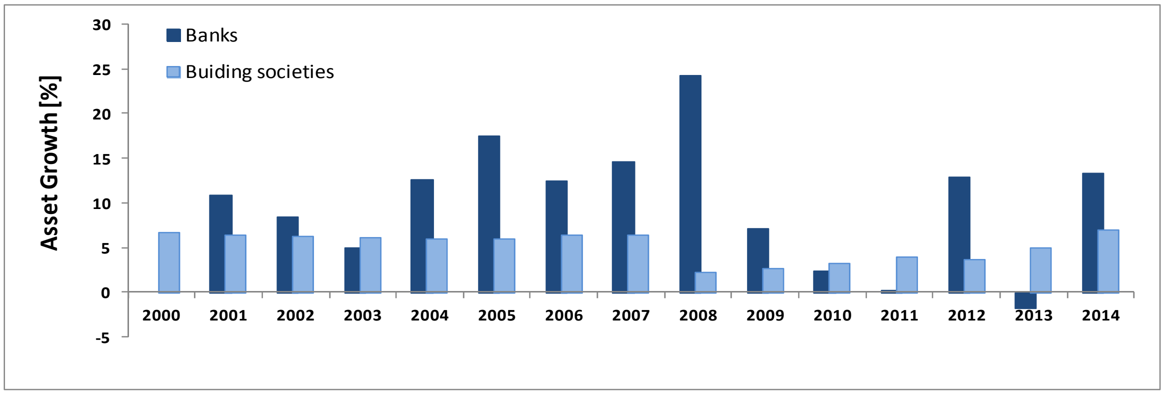
		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Banks																
	Number	**22**	**24**	**25**	**26**	**27**	**23**	**23**	**25**	**25**	**26**	**27**	**29**	**29**	**28**	**17**
	Total Assets	**47,630**	**47,354**	**47,326**	**48,983**	**89,987**	**115,354**	**132,515**	**142,150**	**227,941**	**180,462**	**179,142**	**180,006**	**173,219**	**163,736**	**312,701**
	St.Dev.	*57,742*	*60,487*	*60,689*	*66,752*	*154,859*	*210,210*	*233,273*	*290,833*	*506,208*	*355,618*	*370,881*	*389,630*	*360,173*	*320,843*	*437,850*
	Deposits	**38,160**	**38,216**	**37,751**	**40,233**	**65,160**	**78,267**	**93,788**	**91,944**	**108,380**	**116,865**	**111,557**	**105,654**	**104,062**	**102,594**	**149,563**
	St.Dev.	*46,815*	*50,136*	*48,697*	*54,109*	*91,908*	*111,830*	*135,169*	*153,297*	*172,350*	*176,538*	*196,302*	*192,554*	*184,375*	*180,446*	*219,062*
	Total Loans	**30,057**	**30,660**	**32,886**	**34,445**	**48,396**	**59,262**	**65,681**	**66,277**	**84,443**	**80,746**	**83,445**	**74,292**	**68,583**	**66,763**	**136,178**
	St.Dev.	*33,541*	*36,630*	*40,159*	*44,428*	*59,862*	*76,917*	*83,688*	*102,450*	*130,165*	*128,500*	*133,732*	*121,913*	*108,296*	*107,552*	*161,556*
	Fixed Assets	**531**	**487**	**483**	**480**	**558**	**444**	**437**	**473**	**623**	**699**	**805**	**636**	**736**	**667**	**1,311**
	St.Dev.	*1,007*	*984*	*1,033*	*1,066*	*1,115*	*737*	*708*	*800*	*1,153*	*1,361*	*1,498*	*1,083*	*1,394*	*1,142*	*2,160*
Building societies																
	Number	**64**	**64**	**64**	**64**	**63**	**63**	**60**	**59**	**53**	**52**	**48**	**47**	**46**	**45**	**44**
	Total Assets	**2,369**	**2,652**	**2,855**	**3,246**	**3,749**	**4,261**	**4,907**	**5,262**	**6,555**	**6,371**	**6,447**	**6,556**	**6,953**	**7,052**	**7,398**
	St.Dev.	*8,278*	*9,224*	*9,694*	*11,122*	*13,205*	*14,728*	*16,338*	*18,534*	*25,083*	*28,147*	*27,860*	*27,878*	*29,260*	*28,834*	*29,168*
	Deposits	**544**	**599**	**594**	**781**	**1,029**	**1,207**	**1,368**	**1,578**	**1,985**	**1,634**	**1,564**	**1,498**	**1,619**	**1,578**	**1,502**
	St.Dev.	*2,153*	*2,105*	*1,867*	*2,475*	*3,626*	*4,072*	*4,313*	*5,466*	*7,711*	*8,168*	*7,958*	*7,686*	*8,197*	*7,476*	*6,695*
	Total Loans	**1,808**	**2,008**	**2,178**	**2,480**	**2,905**	**3,338**	**3,872**	**4,158**	**5,087**	**4,798**	**5,057**	**5,158**	**5,480**	**5,867**	**6,356**
	St.Dev.	*6,187*	*6,889*	*7,360*	*8,522*	*10,436*	*12,034*	*13,498*	*15,449*	*19,985*	*21,592*	*22,174*	*22,077*	*23,043*	*24,154*	*25,559*
	Fixed Assets	**24**	**26**	**27**	**29**	**31**	**31**	**30**	**32**	**36**	**36**	**41**	**47**	**51**	**57**	**57**
	St.Dev.	*91*	*93*	*98*	*104*	*112*	*115*	*98*	*108*	*136*	*155*	*186*	*218*	*242*	*270*	*273*

Note: For Building societies Deposits include deposits and debt securities; Total Loans include loans and advances to customers; Fixed Assets include intangible + tangible fixed assets. Source: Data from Bankscope and BSA; author's calculations.

4.1 Lending and Asset Growth

Figure 14 illustrates the asset growth of banks and building societies over the sample period. Although growth has been positive for both groups, banks have outperformed building societies in the run up to the financial crisis.

Figure 14. Asset Growth (%)



Source: Bankscope; Building Societies Association (BSA) and author's calculations. The average asset growth for the two groups is calculated as Year on Year growth of individual institutions averaged across the group.

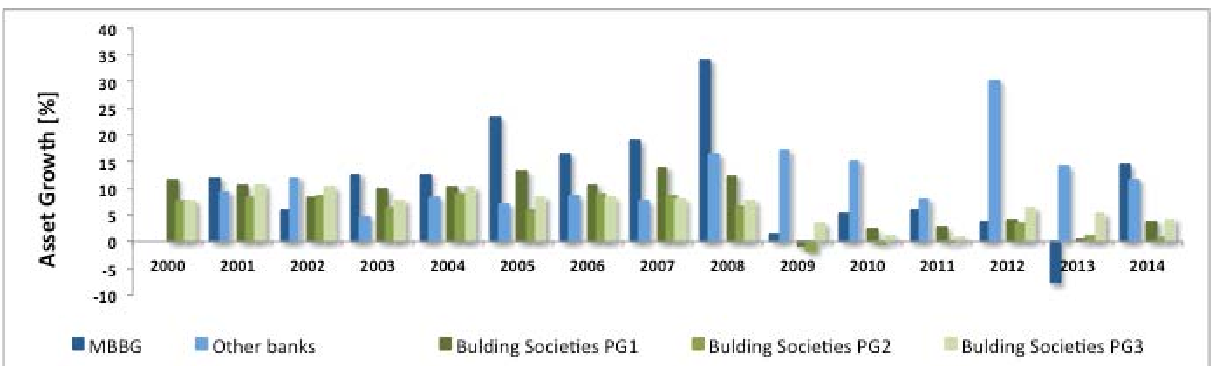
The strong growth in the period 2004-2008 is driven mainly by the MBBGs, as detailed in Figure 14. Note that the asset growth in 2008 is mainly driven by crisis-induced consolidation. Asset growth figures for Barclays and Royal Bank of Scotland include the acquisition of ABN AMRO. Post 2008, the trend reverses for MBBGs, with the largest banks engaged in deleveraging and divesting non-core assets. The negative asset growth in the MBBGs group in 2013 relates to the divestment of TSB from Lloyds Banking Group and the continued restructuring at RBS. Indeed, the nationalised bank is currently half of the size it was in 2008, when it reached a £2.4 trillion balance sheet. RBS is winding down many of its operations in Asia, as part of a plan to retreat from many of its global operations and refocus on the UK retail and corporate clients. Although not with the same magnitude as RBS, other large UK banks such Barclays and HSBC have also been undergoing major reorganisation, with a view to cut costs and decrease assets. The positive trend among banks in

2013 and 2014 is mainly driven by new entrants in the market, including Metro Bank, One Savings Bank and Virgin Money.

Growth in the building societies sector was also positive and sustained between 2000 and 2008. Although the general expectation is that asset growth for building societies is likely to be slower but more stable than for banks, here were nonetheless a few institutions whose fast growth outpaced the market. For example, between 2002 and 2008 Kent Reliance Building Society (KRBS) was the fastest growing in the sector. KRBS got into trouble at the height of the financial crisis and in February 2011 it was transferred to a new financial entity, OneSavings Bank.

During the recession years, building societies' lending was limited. The sector, however, seems to have recovered from the financial turmoil faster than their banking counterparts, asset growth has been on average positive since 2010, although at lower rates than in the pre-crisis period.

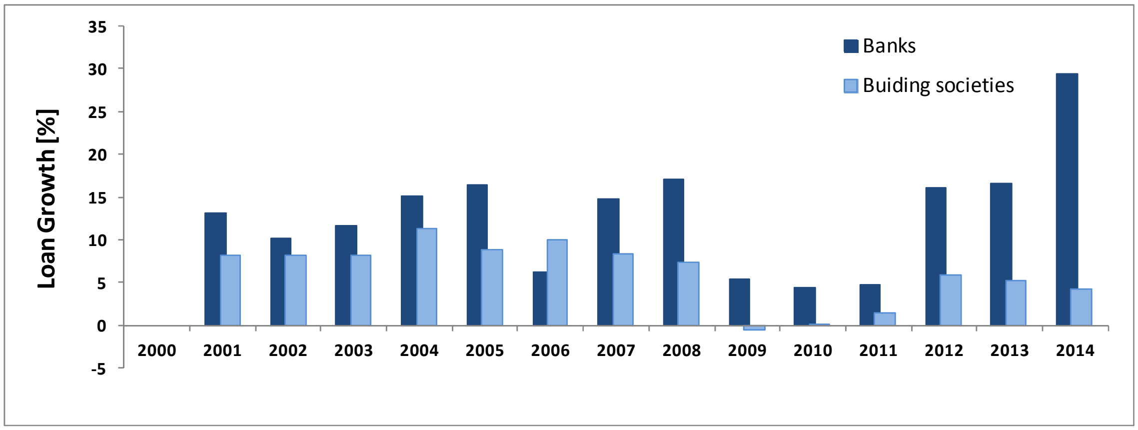
Figure 15. Asset growth MBBGs and Peer Groups



Source: Bankscope; Building Societies Association (BSA) and author's calculations**.** The average asset growth for the five groups is calculated as Year on Year growth of individual institutions averaged across the group.

Fast asset growth and lending growth are often considered as indicators of increased risk-taking in the financial sector. In particular, banks with high rates of loan growth in the pre-crisis period reported a more significant drop in their performance during the crisis (ECB, 2010). Figures 16 and 17 illustrate the rate of loan growth (year on year) for banks and building societies over the sample period.

Figure 16. Loan Growth (%)

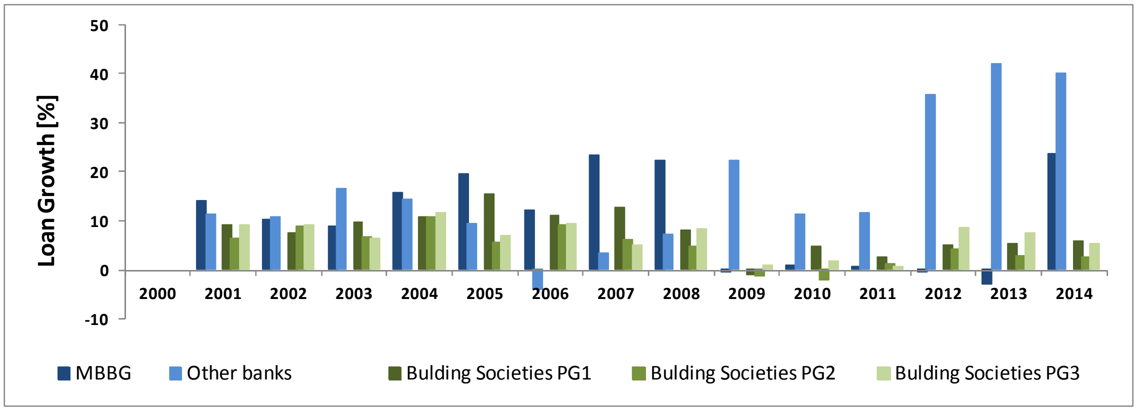


Source: Bankscope; Building Societies Association (BSA) and author's calculations**.** The average loan growth for the two groups is calculated as Year on Year growth of individual institutions averaged across the group.

Loan growth in both sectors has been positive and sustained over the period 2000-2006. Figure 17 illustrates the breakdown of new lending among the different groups. While average loan growth was mainly driven by the large banking groups in the pre-crisis period, a different picture emerges from 2009 onwards. "Other banks", in particular the new entrants in the market, record the highest increases in year- on-year lending, thus increasing their market share. The increase in new lending, illustrated in Figure 5, has been mainly fuelled by these new institutions, as well as some strong performance by High Street Banks.

Lending growth, although positive in recent years, has slowed down for most building societies, particularly the larger ones.

Figure 17. Loan growth MBBGs and Peer Groups

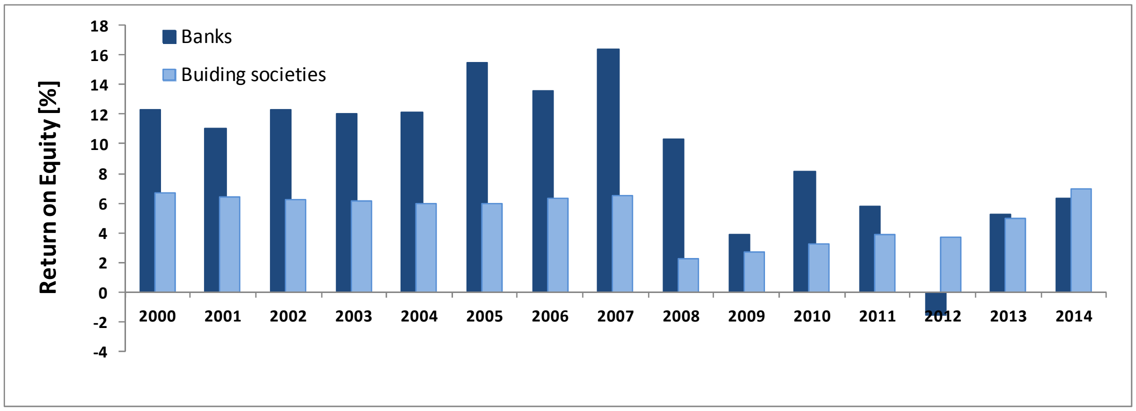


Source: Bankscope; Building Societies Association (BSA) and author's calculations**.** Source: Bankscope; Building Societies Association (BSA) and author's calculations**.** The average loan growth for the two groups is calculated as Year on Year growth of individual institutions averaged across the group.

4.2 Performance Indicators

There are a variety of measures used to assess bank performance, with various stakeholders (e.g. depositors, debt or equity holders, managers as well as market participants, analysts, rating agencies, consultants and regulators) emphasising different aspects of profitability. As we aim to analyse the comparative performance of banks and building societies, we need to take into account that each group of stakeholders and market participants has its own set of goals, and therefore these diverse views need to be taken into account. We consider different indicators of bank performance: (i) traditional accounting measure of performance, the return on equity (ROE) and the return on assets (ROA); (ii) a measure of the traditional intermediation function, the net interest margin (NIM); and (iii) an indicator of efficiency, the cost to income ratio.

Figure 18. Return on Equity

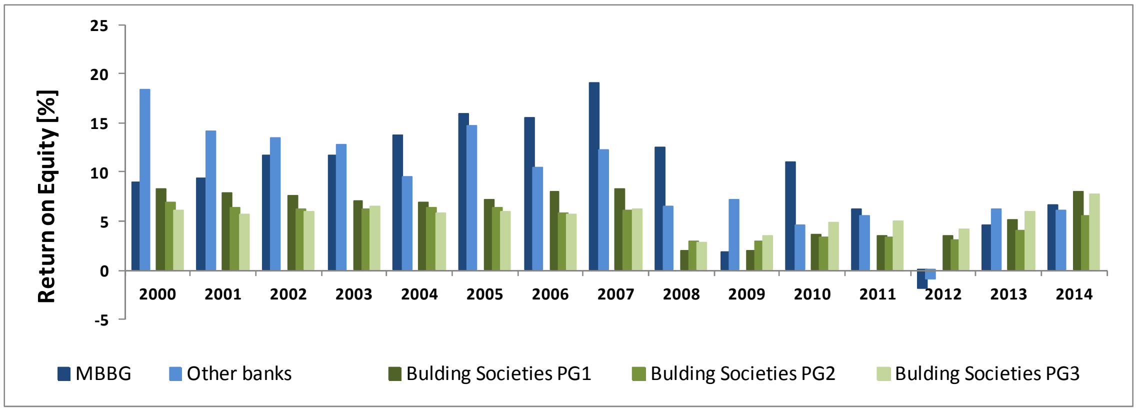


Source: Bankscope; Building Societies Association (BSA) and author's calculations**.**

ROE is an internal performance measure of the financial return of a shareholder's investment, and it is by far the most popular measure of bank performance as it relies on publicly available accounting information. It is estimated as net income/total equity and represents the rate of return to shareholders or the percentage return on each £ of equity invested. It order to carry out meaningful comparisons, it is necessary to note that most of building societies' capital is retained earnings, which do not need to be remunerated. Although building societies report the component of the ROE in their annual accounts, the figure shows the rate of growth of capital, rather than demonstrating returns to investors. Though informative, ROE is typically expected to be lower than for banks. This expectation is confirmed by the figures displayed in Figure 18, which indicates substantially higher ROE for banks. Large losses recorded by the largest banks, for example RBS, have impacted on the banking sector recent performance.

In recent years, the banking sector has not delivered the two digits ROE that had become common in the pre-crisis period and have displayed returns not dissimilar to those of building societies.

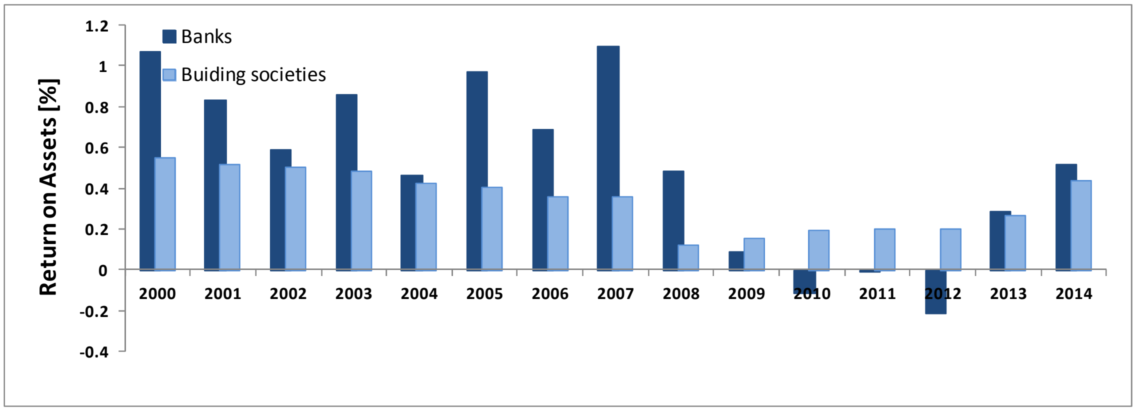
Figure 19. Return on Equity MBBGs and Peer Groups



Source: Bankscope; Building Societies Association (BSA) and author's calculations**.**

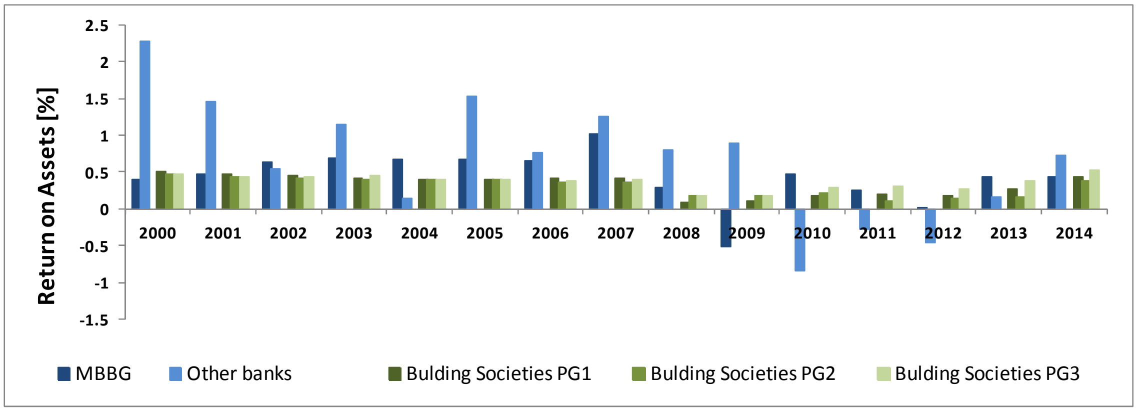
A similar trend is found when considering the Return on Assets (ROA). ROA is calculated as net income / total assets and indicates how much net income is generated per £ of assets. Again, building societies ROA are generally expected to be lower than those generated by banks, as they do not seek to maximise profits. This expectation is confirmed when looking at the pre-crisis period. However, building societies have been consistently generating positive returns on assets during the crisis and ensuing recession period, as illustrated in Figure 20.

Figure 20. Return on Assets



Source: Bankscope; Building Societies Association (BSA) and author's calculations**.**

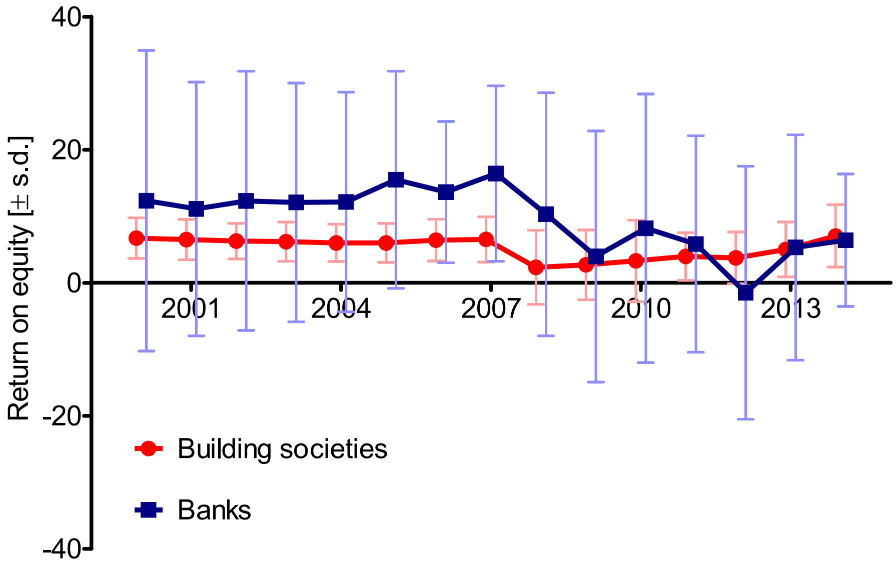
Figure 21. Return on Assets MBBGs and Peer Groups



Source: Bankscope; Building Societies Association (BSA) and author's calculations.

When considering the breakdown into peer groups, it is apparent that 'other banks' have generated the highest and lowest ROA over the sample period. The literature indicates that while the ability to generate earnings is key to bank performance, it is also important to take account of the composition and volatility of those earnings to reflect the risk undertaken to generate them.

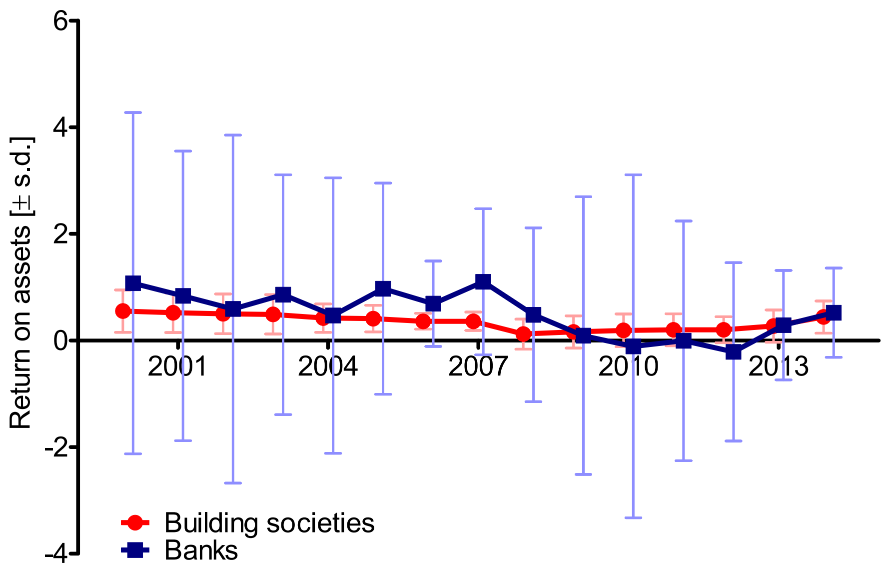
Figure 22. Volatility of Return on Equity



Source: Bankscope; Building Societies Association (BSA) and author's calculations.

Measuring bank performance therefore requires analysts to take into account jointly bank performance and the volatility of performance. Figures 22 and 23 illustrate the volatility of ROE and ROA respectively. While the average ROE is higher for banks than for building societies in boom periods (2000 to 2007), the volatility of returns (measured as the standard deviation of the sample ROE) is also higher (as indicated by the standard deviation of returns, captured by the vertical bars). Although lower on average, building societies' returns are more stable and, notwithstanding a dip in 2008, recover faster than those of banks.

Figure 23. Volatility of Return on Assets

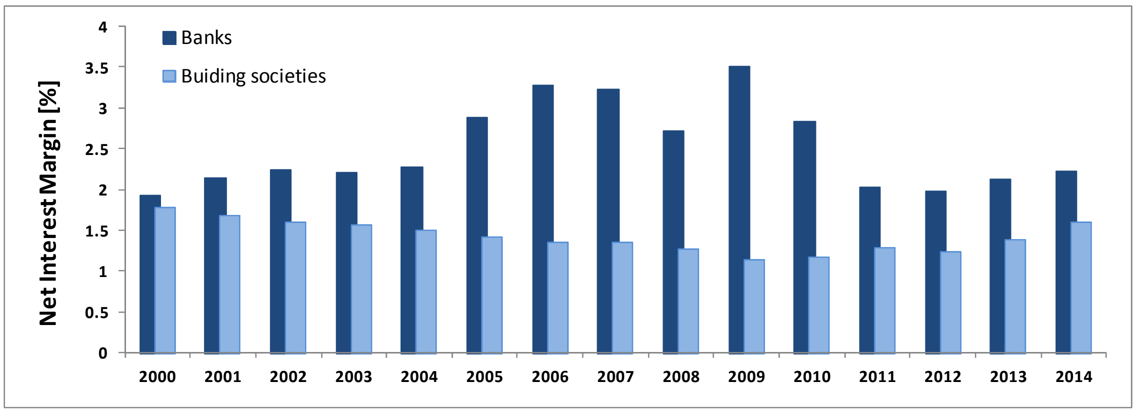


Source: Bankscope; Building Societies Association (BSA) and author's calculations**.**

The next indicator of performance we consider is the Net Interest Margin (NIM), measured as the difference between interest income and interest expenses as a percentage of total assets. It measures the ability of managers to perform banks' primary intermediation function by managing assets and liabilities as to maximise the spread between the interest income earned on assets and the interest costs of liabilities.

Building societies will typically have a lower net interest margin than banks, as they tend to offer higher saving rates and/or lower mortgage rates to their customers, as a way to provide value rather than returns. This is confirmed by the trend illustrated in Figure 24, as banks display consistently higher NIMs over the sample period. The difference increases over the crisis period and reduces from 2011 onwards.

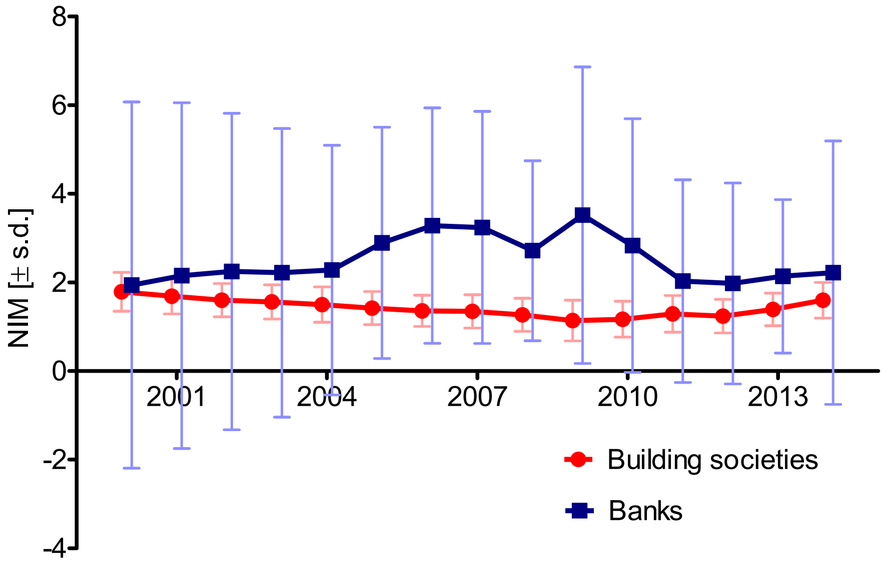
Figure 24. Net Interest Margin



Source: Bankscope; Building Societies Association (BSA) and author's calculations**.**

It is important to note that NIM is also affected by bank risk-taking decisions, as riskier assets yield higher interest. A high NIM can be the results of a decrease in lending standards and derive from a risky loan portfolio. Or it can be the result of credit constraints and reduced availability of credit. Therefore, the volatility of NIM is considered an indicator of bank risk.

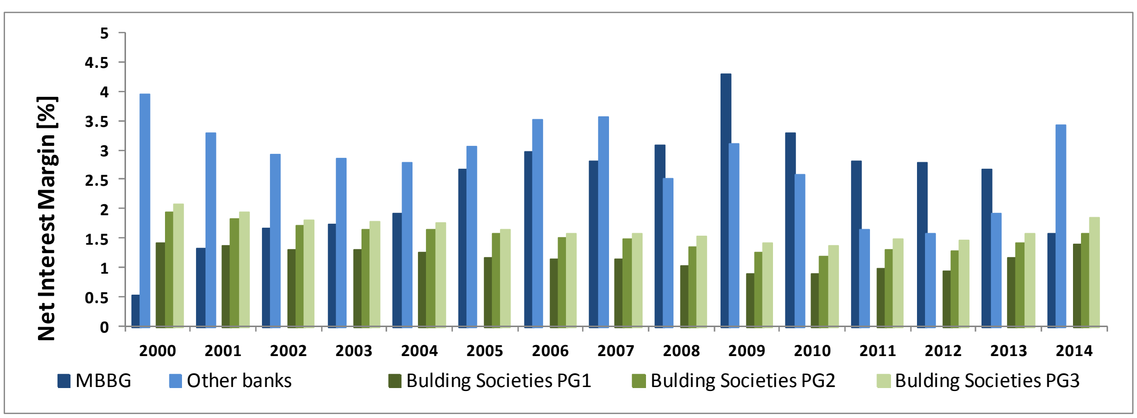
Figure 25. Volatility of Net Interest Margin



Source: Bankscope; Building Societies Association (BSA) and author's calculations.

As illustrated in Figure 25, the volatility of NIM is also much higher for banks, driven particularly by 'other banks'. The MBBGs had relatively low NIMs up to 2004, although ratios increased between 2006 and 2009, at the height of the financial crisis. Conversely, building societies' NIMs have remained fairly stable during the sample period, with the largest changes experienced by the largest building societies.

Figure 26. Net Interest Margin- MBBGs and Peer Groups

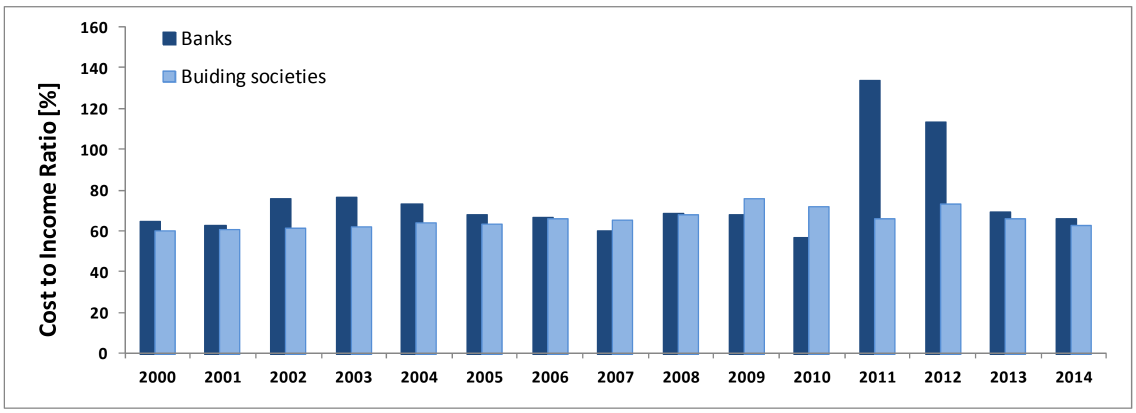


Source: Bankscope; Building Societies Association (BSA) and author's calculations.

The cost/income (C/I) ratio is a quick test of efficiency that reflects non-interest costs as a proportion of income. Building societies might fare unfavourably on this ratio, for two reasons. On the cost side, most building societies are small and therefore might be unable to achieve cost saving deriving from economies of scale. On the profit side, as building societies are not profit maximisers, they might generate lower operating profits per £ of non-interest expenses. For an institution to be operating efficiently, the C/I ratio should be in the 50-70 per cent range, with higher ratios indicating lower efficiency.

Contrary to predictions, building societies C/I ratios are not, on average, higher than those of banks, with the sector displaying good levels of efficiency and ratios around 60% on average during the sample period. Two new entrants in the market, Metro Bank and Virgin Money, who enter with initial very high costs, drive the increase in C/I ratios in 2011 and 2012.

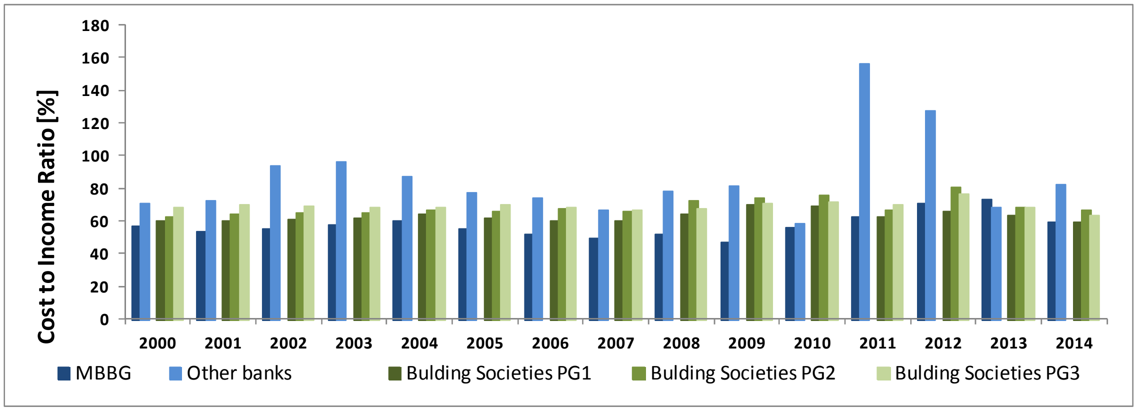
Figure 27. Cost to Income Ratio



Source: Bankscope; Building Societies Association (BSA) and author's calculations.

The impact of the entry of new competitors is clearly illustrated in Figure 28. MBBGs have on average lower C/I ratios compared to all other institutions in the market, as they steadily maintain rations of around 60% on average. Other banks have higher C/I than building societies, on average.

Figure 28. Cost to Income Ratio - MBBGs and Peer Groups



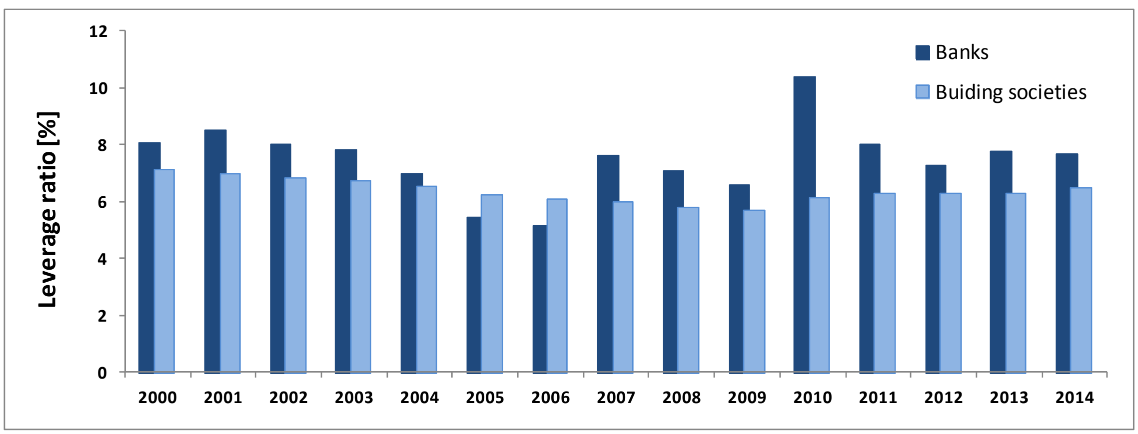
Source: Bankscope; Building Societies Association (BSA) and author's calculations.

4.3 Solvency and Stability Indicators

An evaluation of the performance of UK banks and building societies would not be complete without considerations about solvency and stability.

As building societies cannot readily raise external capital and rely on accumulated reserves they tend to have higher capital ratios compared to banks as they often accumulate voluntary buffers in excess of regulatory standards. In addition, most societies use the standardised approach to risk weightings in assessing capital adequacy (with the exception of Nationwide, Coventry and Principality).

Figure 29. Leverage Ratio

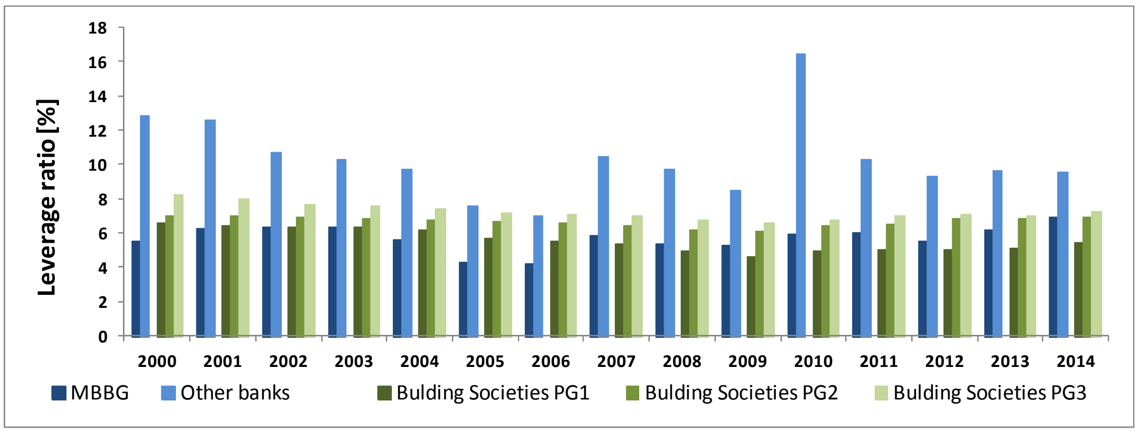


Source: Bankscope; Building Societies Association (BSA) and author's calculations.

The new Basel III regulatory framework introduced a definition of leverage ratio as a capital measure over an exposure measure. The capital measure is the Tier 1 capital of the risk-based capital framework. The exposure measure relates to "total adjusted assets" that includes: on-balance sheet exposures; derivatives exposures; securities financing transactions (SFTs) and off-balance sheet (OBS) items. The minimum leverage ratio under Basel III is 3%, a figure that has been endorsed by the Bank of England and is to become the basic minimum by 2019 for all PRA-regulated institutions.

MBBGs have, on average, lower leverage ratios compared to the rest of the sector. Large banking groups have been increasing leverage in the run up to the crisis, while other banks are, on average, better capitalised. However, all groups meet the regulatory leverage minimum of 3%. The spike in the figure for 2010 for banks is driven by the entry of Metro bank, with a high initial leverage ratio, as also illustrated in Figure 30.

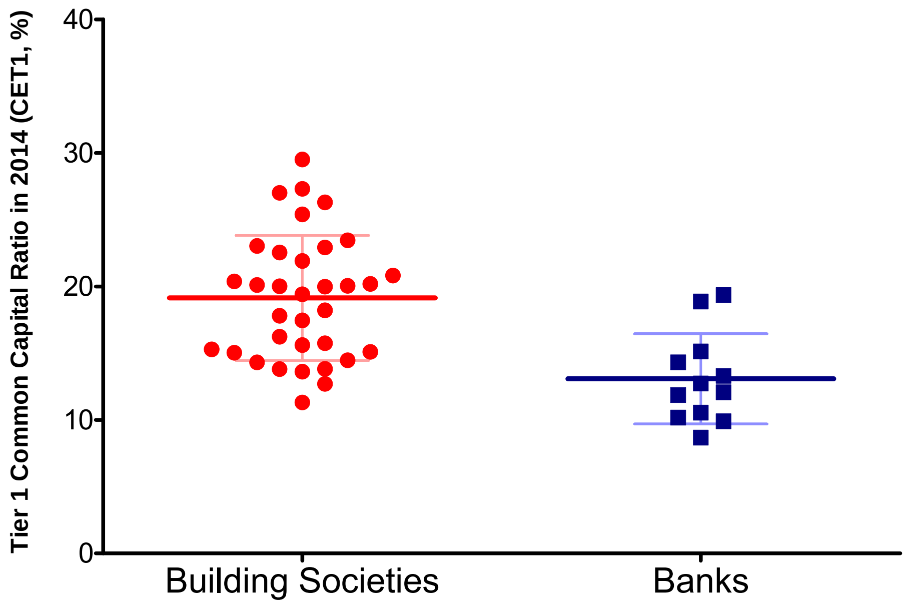
Figure 30. Leverage Ratio - MBBGs and Peer Groups



Source: Bankscope; Building Societies Association (BSA) and author's calculations.

A snapshot of the regulatory capital position of banks and building societies is provided in Figure 31.

Figure 31. Tier 1 Common Capital Ratio



Source: SNL Financial; Building Societies Association (BSA) and author's calculations**.**

Building societies are, on average, better capitalised with CET1 ratios significantly above the regulatory minimum. The spread, however, is bigger than that in the banking sector.

An increasingly popular measure of bank stability is the z-score, a measure of the distance from insolvency for a given institution which combines profitability, capitalisation and volatility of returns. The z-score estimates the number of standard deviations that an institution's profits have to fall below its expected value before its equity becomes negative and is defined as:

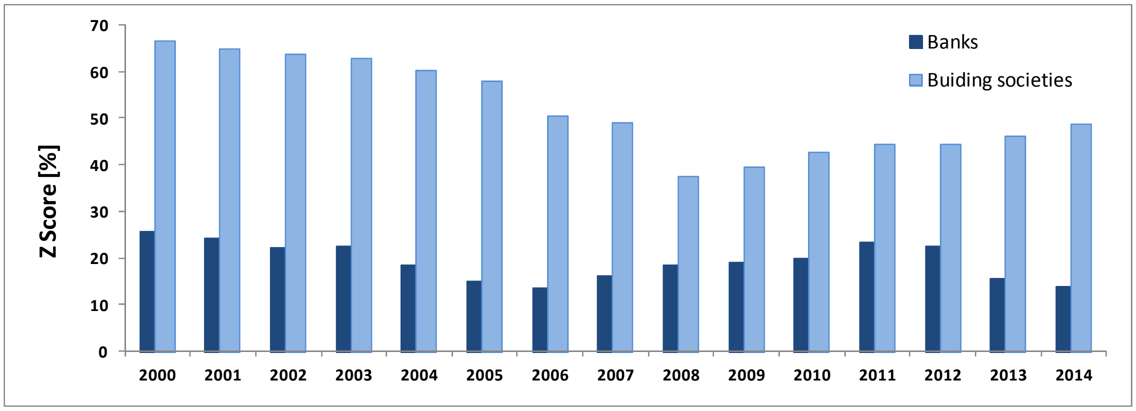
$$Z = \frac{\overline{ROA} + \overline{EA}}{\sigma_{ROA}}$$

where $\overline{ROA}$ is the average return on assets, $\overline{EA}$ is the average equity capital ratio, and σ_{ROA} is the standard deviation of return on assets.

A higher z-score indicates that a bank is more stable, or the less likely it is that the bank will become bankrupt. In other words, a higher z-score value indicates lower risk.

Building societies' are expected to have higher z-scores, as they are expected to have lower, but more stable earnings, and stronger capital positions than banks. These expectations are borne out by the results of the analysis. Figure 32 illustrates the z-scores of banks and building societies. The latter are significantly higher over the sample period although the gap reduces slightly during the 2007-2009 period.

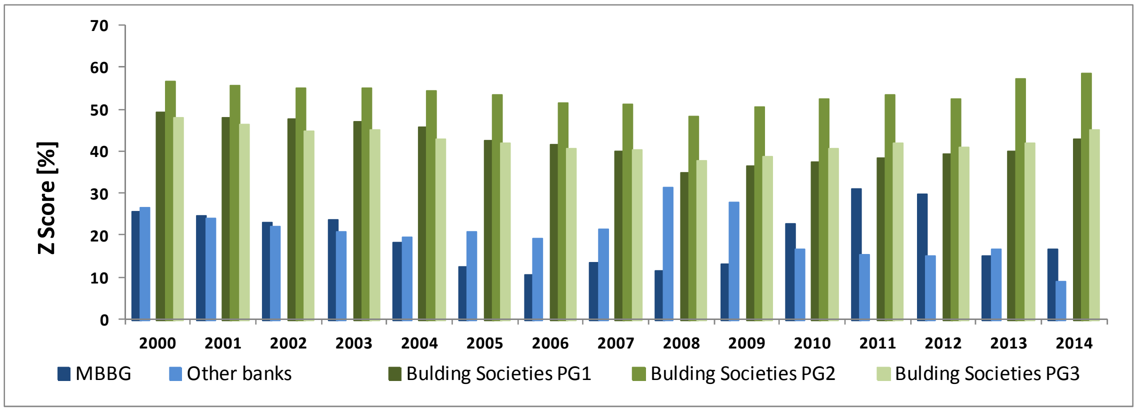
Figure 32. Z-score



Source: Bankscope; Building Societies Association (BSA) and author's calculations**.**

When analysing the different groups, MBBGs display the lowest z-scores (or the highest probability of default) during the crisis period, whereas 'other banks' seem to have a highest probability of insolvency in the post crisis-period. This is probably due to new entrants having a higher volatility of returns. Within the building societies sector, the medium-size building societies (PG2) have the highest z-scores (or lowest probability of default).

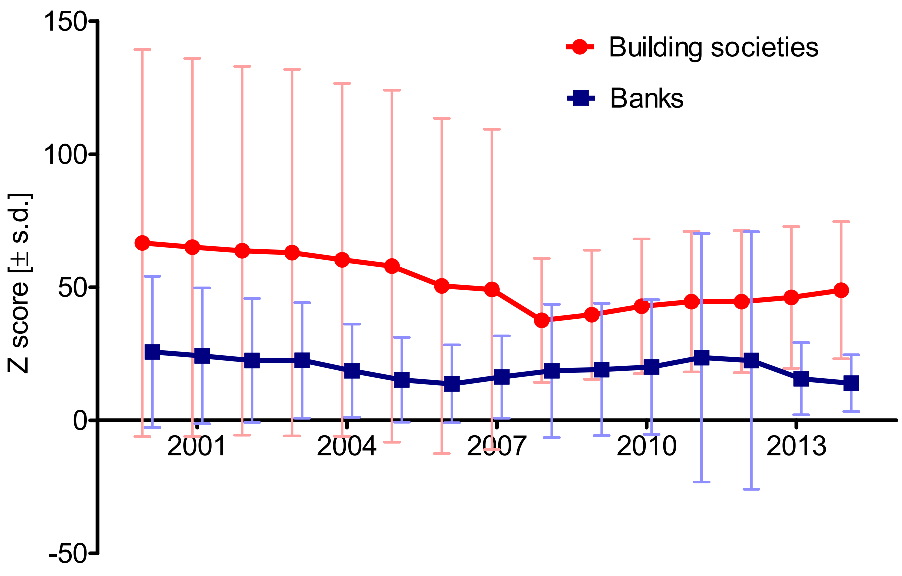
Figure 33. Z-score - MBBGs and Peer Groups



Source: Bankscope; Building Societies Association (BSA) and author's calculations**.**

In analysing z-scores, key information relates to the stability of the indicator with higher volatility indicating higher instability.

Figure 34. Volatility of Z-score



Source: Bankscope; Building Societies Association (BSA) and author's calculations**.**

Although building societies have maintained, on average, higher z-scores compared to banks, the standard deviation of z-scores was much higher in the pre-2007 period. Remarkably, the building societies sector has managed to reduce the volatility of z-scores during a period of increased market turbulence and have consistently outperformed the banking sector, in terms of financial stability, both with higher z-scores and lower volatility from 2009 onwards.[4] This indicates that the sector is in overall good health despite the challenging economic environment. With both the economy and the housing market showing sign of recovery, the outlook is very positive.

5. SUMMARY

The report presents a comparative analysis of the performance of UK banks and building societies over the period 2000- 2014. The results highlight the substantial impact of the financial crisis on the sector.

Return on Equity and Return on Assets decreased for both groups in the wake of the financial turmoil, with 2008 and 2009 being particularly difficult years. As the UK economy shows signs of recovery, the outlook is positive for both groups: banks and building societies have recovered some profitability, although not at the pre-crisis level. Asset and loan growth are mildly positive and the entry of new competitors seems to have had an encouraging effect on activity.

Capitalisation ratios are above the regulatory guidelines and both groups seem to be in a position to meet the regulatory minimum leverage ratio.

Building societies in particular have recovered well from the financial turmoil and they appear less risky than banks on a variety of measures, from lower volatility of earnings, lower volatility of NIMs and higher z-scores. Their recent performance should put them in good stead to face the challenges driven by regulatory pressure and reform.

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[4] The reduction in volatility is mainly driven by the fact that those building societies with very high or very low z-scores were also those that merged during the crisis period. For example, the Catholic Building Society was an outlier in the years prior to its merger with Chelsea Building Society in December 2008. Further consolidation ensued when the Chelsea merged with the Yorkshire Building Society in April 2010.

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Appendix 1: Demutualisation of the UK building society sector (1989 - 2015)

Year	***Building Society Name***	**Nature of Conversion or Acquisition and Where are now (2015)**
1989	Abbey National	Converted to plc and bank status in July 1989. Acquired by Santander in November 2004. Rebranded to Santander in January 2010.
1995	Cheltenham & Gloucester	Acquired by Lloyds TSB in August 1995. In 2013 Cheltenham & Gloucester branches and accounts were transferred to TSB, within the Lloyds Banking Group. TSB was revived, as a separate brand after the EU demanded Lloyds Banking Group spin off 631 branches as a condition of its £20bn bailout by taxpayers in 2008. TSB has been sold to Spanish bank Sabadel in 2015.
1996	National & Provincial	Acquired by Abbey National in August 1996.
1997	Alliance & Leicester	Converted to plc and bank status in April 1997. Acquired by Santander in 2008 and rebranded as Santander in 2010.
1997	Halifax	Halifax and Leeds Permanent Building Societies merged in 1995; the new Halifax then converted into plc and bank status in June 1997. Halifax merged with the Bank of Scotland in September 2001 to form HBOS. In 2008 Lloyds Bank agreed to take over HBOS, which became part of the Lloyds Banking Group in 2009.
1997	Woolwich	Converted to a bank in July 1997 and acquired by Barclays in October 2000.
1997	Bristol & West	Acquired by the Bank of Ireland in July 1997. Bristol & West transferred its branch network and accounts to Britannia Building Society in 2005. This was the first remutualisation of a converted institution. Britannia became part of the Co-op Banking Group in 2009, the first merger between a building society and a mutual bank made possible under the 2007 'Butterfill Act'. It is currently (2015) being rebranded to Co-operative Bank.
1997	Northern Rock	Converted to bank status in October 1997. Northern Rock failed in 2008 and was transferred into public ownership. In 2010 was split into two entities, Northern Rock plc and Northern Rock Asset Management. In 2011 Northern Rock plc was sold to Virgin Money, which rebranded all Northern Rock branches in 2012. Northern Rock Asset Management was integrated into a new holding company, UK Asset Resolution (UKAR).

1999	Birmingham Midshires Building Society	Acquired by Halifax in April 1999. The Halifax merged with the Bank of Scotland in September 2001 to form HBOS.Birmingham Midshires Building Society is now part of Lloyds Banking Group, as a division of the Bank of Scotland.
2000	Bradford & Bingley	Converted to bank status in December 2000. It was the last, to date, to convert. Bradford & Bingley failed in 2008 and was transferred into public ownership. In 2010 it was integrated into a new holding company, UK Asset Resolution (UKAR).

Appendix 2: Major British Banking Groups (MBBGs)

Year	***Banking Group Name***	**Subsidiaries**
1985 - 1996	The Standard Chartered Group	Chartered Trust plc Chartered WestLB Ltd (up to) Standard Chartered Bank
1985 - 1994	The TSB Group	Hill Samuel Bank Ltd (from 1987) TSB Bank plc TSB Bank Northern Ireland plc (up to 1991) TSB Bank Scotland plc
Until 1994	The Lloyds Group	United Dominions Trust Lloyds Bowmaker Ltd Cedar Holdings Ltd (form 1981 to 1988) Lloyds Bank plc Lloyds Bank (LABCO) Ltd (up to 1986) Lloyds Bank International Ltd (merged into Lloyds Bank plc in 1986) Lloyds Bank Finance (Jersey) Ltd (up to 1992) Lloyds Private Banking Ltd (from 1992) LMB Services Ltd (from 1985 up to 1993) The National Bank of New Zealand Ltd (up to 1991)
1995 -2008	The Lloyds TSB Group	AMC Bank Ltd Black Horse Ltd (2001 & 2002 only) Cheltenham & Gloucester plc (up to 2006) Hill Samuel Bank Ltd (up to 1998) Lloyds Bank (BLSA) Ltd (from 1998 to 2002) Lloyds TSB Bank Plc Lloyds TSB Private Banking Ltd Lloyds TSB Scotland plc Lloyds UDT Ltd (up to 2002) Scottish Widows Bank plc (from 2000) TSB Bank plc (up to and including 1998 when it merged with Lloyds Bank) United Dominions Trust Ltd (1997 only)
From 2009	The Lloyds Banking Group	Halifax plc (up to 2006) Bank of Scotland (from 2009) HBOS Treasury Services plc (up to 2006) Capital Bank plc (up to 2006) Lloyds TSB Bank Plc (from 2009) AMC Bank Ltd (from 2009) Cheltenham & Gloucester plc (up to 2006) Lloyds TSB Private Banking Ltd (from 2009) Lloyds TSB Scotland plc (from 2009) Scottish Widows Bank plc (from 2009)
Until 2008	Alliance & Leicester Group	Alliance & Leicester plc Alliance & Leicester Commercial Bank plc (from 2003 to 2006) Alliance & Leicester Group Treasury plc (up to 2001)

2000 - 2009	Bradford & Bingley plc	Bradford & Bingley failed in 2008 and was transferred into public ownership. In 2010 it was integrated into a new holding company, UK Asset Resolution (UKAR).
1999 - 2008	Northern Rock Group	Legal & General Bank Ltd (2002 only) Northern Rock plc
Until 1999	The National Westminster Group	County NatWest Ltd (up to 1994) Coutts & Co Coutts Finance Co (up to 1989) Gartmore Money Management Ltd (from 1996) International Westminster Bank plc (merged into National Westminster Bank PMV in 1989) Isle of Man Bank (up to 1981) Lombard Bank (Isle of Man) (up to 1992) Lombard Bank Ltd (from 1987) Lombard Banking (Jersey) (up to 1992) Lombard North Central PLC Lombard & Ulster Ltd (from 1985) National Westminster Bank PLC National Westminster Bank Finance (C.I.) Ltd (up to 1989) Ulster Bank Ltd (from 1985) Ulster Bank Trust Company (from 1987 to 1990) Ulster Investment Bank Ltd (from 1985)
2015	The Royal Bank of Scotland Group	Adam and Company plc (from 1993) Charterhouse Bank Ltd (from 1985 to 1993) Charterhouse Japhet PLC (1986 and 1987 only) Coutts & Co (from 2000) Cripps Warburg Ltd (up to 1981) Direct Line Financial Services (up to 2006) GEM Money Management Ltd (up to 2002) Lombard Bank Ltd (from 2000 to 2005) Lombard North Central PLC (from 2000 to 2003) Lombard & Ulster Ltd (from 2000) National Commercial & Glyn's Ltd (up to 1986) National Westminster Bank PLC (from 2000) RBS Trust Bank Ltd (up to 1998) Royal Bank of Scotland NV (from 2011) RoyScot Trust plc (from 1981 to 2002) Tesco Personal Finance Ltd (from 1998) The Royal Bank of Scotland plc Ulster Bank Ltd (from 2000) Ulster Bank Ireland Ltd (from 2000) Williams & Glyn's plc (merged into The Royal Bank of Scotland plc in 1985) Williams & Glyn's Bank Investments (Jersey) (up 1981) Williams & Glyn's Bank Investments (Guernsey) (up to 1981) Williams & Glyn's Bank Investments (Isle of Man) (up to 1981)
1991 - 2008	The Abbey National Group	Abbey National plc (including retail deposits of Bradford & Bingley from 2008) Abbey National Treasury Services plc CA Premier Banking (from 2001 to 2005)

		Cater Allen (from 1997) First National Bank plc (from 1995) First National Commercial Bank plc (from 1995 up to and including 1997)
From 2009	Santander UK Group	Santander UK (including retail deposits of Bradford & Bingley from 2008) Abbey National Treasury Services plc CA Premier Banking (up to 2005) Cater Allen Alliance & Leicester plc (from 2008) Alliance & Leicester Commercial Bank plc (from 2003 to 2006)
1997 to 2000	Halifax plc	
Until 2000	The Bank of Scotland Group	Bank of Scotland Bank of Scotland Treasury Services plc (from 1992) Bank of Wales plc (from 1986 up to 2001) Capital Bank (formerly NWS Bank plc) (from 1981) The British Linen Bank Ltd
2001 - 2008	The HBOS Group	Bank of Scotland Bank of Wales plc (up to 2000) Capital Bank plc (up to 2006) Halifax plc (up to 2006) HBOS Treasury Services plc (up to 2006) The British Linen Bank Ltd (up to 2000)
2015	The Barclays Group	Barclays Bank PLC Barclays Bank International Ltd (merged into Barclays Bank PLC in 1985) Barclays Bank Finance Company (Jersey) Ltd (up to 1996) Barclays Bank Trust Company Ltd Barclays Capital Finance Ltd (up to 1997) Barclays de Zoete Wedd Ltd (up to 1998) Barclays Finance Company (Guernsey) Ltd (up to 1996) Barclays Finance Company (Isle of Man) Ltd (up to 1996) Barclays Private Bank Ltd (from 1996 to 2006) Mercantile Credit Company Ltd (up to 1991) Woolwich plc (from 1997 to 2003)
2015	The HSBC Bank Group (formerly Midland Group)	Clydesdale Bank Finance Corporation Ltd. (from 1985 to 1987) Clydesdale Bank plc (up to 1987) Crocker National Bank (from 1981 to 1986) Forward Trust Group (up to 1998) Forward Trust Personal Finance (from 1987 to and 1995) HSBC Asset Finance (UK) Ltd (up to 1999) HSBC Bank plc (formerly Midland Bank plc) HSBC Trust Company (UK) Ltd (formerly Midland Bank Trust Company Ltd) (from 1987) Marks & Spencers Financial Services (from 2011) Northern Bank Development Corporation Ltd (from 1985 to 1987)

		Northern Bank Ltd (from 1985 to 1987) Midland Bank Trust Corporation (Guernsey) Ltd (up to 1991) Midland Bank Trust Corporation (Jersey) Ltd (up to 1991) Midland Bank Trust Corporation (Isle of Man) Ltd (up to 1991) Samuel Montagu & Co Ltd (up to 1993) Samuel Montagu & Co (Jersey) Ltd (merged with Midland Bank Trust Company (Jersey) Ltd in 1988) Samuel Montagu (MFBC) Ltd (up to and including 1977)

Source: British Bankers' Association - Abstract of Banking Statistics

Appendix 3: List of banks and building societies considered in this report

Banks

Airdrie Savings Bank; Alliance & Leicester Plc; Bank of Scotland Plc; Barclays Bank Plc; Bradford & Bingley Plc; Bristol & West Plc; Cheltenham & Gloucester Plc; Clydesdale Bank Plc; Co-operative Bank Plc (The); Habibsons Bank Ltd; Halifax Plc; HBOS Plc; HSBC Bank plc; Julian Hodge Bank; Lloyds Bank Plc; Marks & Spencer Financial Services Plc; Metro Bank PLC; National Westminster Bank Plc – NatWest; Northern Rock; OneSavings Bank Plc; Prudential Five Ltd; Royal Bank of Scotland Group Plc (The); Sainsbury's Bank Plc; Santander UK Plc; Scottish Widows Bank Plc; Secure Trust Bank Plc; Standard Chartered Bank; Tesco Personal Finance Plc; Unity Trust Bank Plc; Virgin Money Plc; Wesleyan Bank Ltd; Woolwich Ltd; Yorkshire Bank Plc

Building Societies

Barnsley; Bath Investment; Beverley; Britannia; Buckinghamshire; Cambridge; Catholic; Century; Chelsea; Chesham; Cheshire; Chorley & District; City of Derry; Coventry; Cumberland; Darlington; Derbyshire; Dudley; Dunfermline; Earl Shilton; Ecology; Furness; Hanley Economic; Harpenden; Hinckley & Rugby; Holmesdale; Ipswich; Kent Reliance; Leeds; Leek United; Loughborough; Manchester; Mansfield; Market Harborough; Marsden; Melton Mowbray; Monmouthshire; National Counties; Nationwide; Newbury; Newcastle; Norwich & Peterborough; Nottingham; Penrith; Portman; Principality; Progressive; Saffron; Scarborough; Scottish; Shepshed; Skipton; Stafford Railway; Stroud & Swindon; Swansea; Teachers'; Tipton & Coseley; Vernon; West Bromwich; Yorkshire; Lambeth; Universal; Mercantile; Clay Cross