

Building Societies - Govt. pays but is 'mutuality' a fiction?.

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The preferential tax treatment afforded to the building societies is costing the State more than £140 million a year, yet the concept of "mutuality" by which they now seek to resist the takeover by the Bank of Ireland of the I.C.S.B.S. is a pure fiction, argues Patrick Shallow, an experienced banker and a former building society chief executive.

Opposition to the purchase, by the Bank of Ireland, of the shares of ICSBS tends to focus on the idea that it would somehow violate the principle of 'mutuality' which, allegedly, informs the spirit of the building society movement. In view of its central role in the present debate it may be helpful to consider the validity and present relevance of this undefined concept.

Reference to the limited literature available and also to the Registrar of Friendly Societies who is its official arbiter and champion, failed to define it.

Some of the key elements of the concept and claims made in respect of it, relate to the ideas of self-help, single-minded commitment to the common purpose of members, to the neglect of profit, an independent and, more or less self-sufficient, system owned by its members.

One can see how the early building and friendly societies, rather like co-operatives and credit unions, operating in a hostile commercial environment, promoted the common good of their members, in their pursuit of home ownership. One can also understand the State's wish to support this objective, tied as it is to the economically and politically important industry of home construction.

However, State support, via the tax system, has progressively altered the nature and direction of building societies in a way that arguably, has little to do with the laudable concept of "mutuality".

The old co-operative idea of there being one homogenous market, where today's investors were tomorrow's borrowers and where penalties of a low interest return on investment today would be compensated by a low mortgage rate tomorrow, is no longer valid.

Today there are two markets: (a) Investors who are free to move in and out building societies in search of the maximum rate of return on savings; (b) Mortgagors who, after a token qualifying period and with an often token deposit, seek mortgages at the lowest rates obtainable. Recognising that there are in practice now two markets within the building society movement, it can no longer be argued that distortions or inefficiencies in one area are compensated in the other area.

In what sense can mutuality be claimed for a system where many non-tax-paying investors and savers receive an artificially depressed interest payment to the benefit of young mortgagors, many single, high income earners who receive mortgages of up to £40,000 at 12% interest equivalent to approximately 4% after tax relief?

The principle of mutuality was ruptured by the introduction of tax privileges which provided a new and ulterior motivation for investors and produced a differential effect on borrowers and lenders.

The second desirable attribute of mutuality is that it should be largely self-sufficient having little

dependence on the public at large.

In theory, building society investors owe nothing to the public at large, since they discharge their full liability to tax by the 'composite rate' tax, of 26.25%.

For several reasons it may be questioned that building societies do in fact discharge their full liability in this manner (this is a question that can only be definitively resolved by analysis of a representative sample of investors).

(a) Building societies refuse to permit a sample investigation, even under pain of an increase in the composite rate.

(b) The demonstrable flight of funds from banks to building societies, presumably in search of the more favourable (and anonymous) composite rate of tax.

(c) The way in which building societies jealously guard the aspect of confidentiality (not essential to building society operations in many other countries) which can also facilitate the making of deposits in excess of the £15,000 ceiling permitted at the standard rate.

To the extent that building society members pay less than their full liability to tax, and enjoy a corresponding subsidy from the public at large, they fail the criterion of "self-help" and lose their independence and right to differential tax treatment.

Substantially dependent upon their tax privileges, they can make no valid claim to self-sufficiency. On the mortgage side, building societies' claim to mutuality and self-help is even more transparent, since both the volume and level of mortgage interest rates are, substantially, functions of the present level of tax relief on mortgage interest, representing a further massive subsidy from the public.

On the basis of total assets of the building society movement at £2,067 million at the end of 1983, it has been estimated that the tax shortfall on the investment side, resulting from the "confidential" application of the composite rate approximately £40m per annum.

Tax relief on total mortgages of £1,843 million is estimated at £95 million producing a total annual subsidy from the State to building society members of some £135 million - a far cry from the self-sufficiency of the early mutual societies. (it may also be regretted that so little of this subsidy is repaid to the government in the form of corporation tax - the societies to growth and advertising and their questionable efficiency has had the result of keeping operating surpluses and tax to the minimum consistent with the reserve requirement).

At least, it may be argued, mutuality confers ownership of the society on its members and promotes the interest of its members exclusively and effectively - or does it?

The curious "ownership" of a building society's assets by all its members, on the basis of one vote per investment, militate against proper accountability on the part of the board to its members.

Once installed, building society directors can continue in perpetuity without being answerable for the range, quality or cost of services, or for the level of operating surplus.

This situation is sustained by the present building society cartel, where the only penalty imposed on inefficiency is the lower rate of growth which it allows the society

A survey of building society services in this country and a comparison with what is available in Britain and in Europe would tend to suggest that as now constituted, Irish societies serve their members poorly.

- (a)** By virtue of the cartel there is no competition between the Big Five on deposit rates and very little choice between account types.
- (b)** Regular Savings Accounts, which pay a premium rate in other countries, are not offered here in this country.
- (c)** Premiums related to the size of investments are not paid by Irish societies.
- (d)** Size-related mortgages, to the benefit of the smaller mortgagor, are not uniformly observed.
- (e)** The tax-efficient Endowment mortgage which can substantially reduce the after-tax cost to members is not offered by four of the Big Five societies (the Nationwide does offer it).
- (f)** Redundancy insurance cover, especially desirable in this country, is not offered by most societies.
- (g)** Irish building society technology is significantly behind that of Europe and Britain, resulting in a less efficient service than could be provided.
- (h)** Restrictive insurance practices do not favour members.

Despite the low quality of services and the paucity of choice (or perhaps because of it) massive expenditure is incurred by the Irish building society movement on advertising. Further, over-elaborate branch networks with branches currently unprofitable, represent an unjustifiable charge to building society members.

The foregoing would suggest that it is not mutuality (insofar as it exists) that promotes the interest of Irish building society investors and mortgagors, but rather the generous Irish taxpayer!

To what extent do building societies achieve their objective and promote home ownership at reasonable cost?

It may now be argued that all building societies now achieve is to provide cheap finance but expensive houses, i.e. that the increased availability of low-cost finance (after tax relief) is substantially translated into increased prices - rather than as the liberal credit policy of banks from 1978 to 1981 cause land prices to rocket.

A survey of building societies results for 1983, published on the 22 nd March, shows a quite remarkable phenomenon - a 19 p.c. increase in building society assets in 1983 met by 14 p.c. increase in the price of second-hand houses and a drop of 2.1 p.c. in the cost of new houses.

The direct inflationary effect of building society credit may be evident here.

In the face of a static or retreating property market, the increasing average size of building society loans would seem to point to the increasing predominance in the mortgage "mix" of the borrower "trading up" rather than the first-time buyer

An important corollary is that the principal beneficiary of building society credit is the vendor of the second-hand house, not the targeted (and beleaguered) building industry.

One wonders if this country can afford a £140 million tax subsidy per annum to the almost exclusive benefit of persons "trading up" and otherwise speculating in residential property - all in the name of increasing home ownership in a country that is already top of the European league.

In the face of more urgent agricultural and industrial priorities, this begins to look like social madness.

The building society movement, it is submitted, has lost its direction and failed its purpose. It is in need, like our tax system, of urgent reform.

In the meantime, if the Bank of Ireland's overtures to ICS are to be rejected it should be on grounds less specious and more substantive than the violation of mutuality.

One feels that a breath of commercial realism, such as the Bank of Ireland might infuse, would serve the public and the movement well.

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