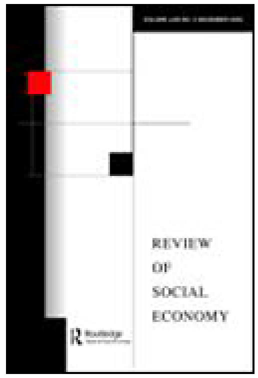

Mutual enmity: deposit insurance and economic democracy

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Economists delight in perversity, such as the idea that private vice promotes public virtue. Our contrarian instinct to identify the unintended consequences of good intentions manifests itself in claims that public spending crowds out private, that higher taxes reduce government revenue, that minimum wages create unemployment, *et hoc genus omne*. This rhetorical trick is normally used to promote a neoliberal agenda but social economists can play the game too. I want to argue that deposit insurance, among other policies nominally intended to protect or promote the interests of individual consumers, has in fact undermined the mutual organizations that serve consumers best in the long run and has ultimately simply concentrated power and served the interests of large institutional investors and their managers.

Between 1989 and 2000, the ten largest UK building societies demutualized and by 2009, none remained as independent entities, having either been acquired by larger banks or nationalized. Demutualization was an indirect consequence of a more general financial liberalization that began in the case of the UK with the deregulation of bank lending in 1971 together with the abolition of exchange controls in 1979 and removal of the 'corset' on bank lending in 1980. These developments, together with the removal of certain tax privileges, undermined the interest rate cartel operated by the Building Societies Association since 1939, of which the main effect had been to keep lending interest rates below market-clearing levels and to limit reckless lending by credit rationing. The tax advantages helped to keep interest rates competitive for savers and had the side-effect of keeping banks out of the mortgage market, with the societies taking a 96% share in 1978.

A similar process of demutualization had begun earlier in the US with the loss of tax privileges and the introduction of the right to convert from the mutual form in the 1950s. The concept of the S&L as a mutual association appears to have withered

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much earlier than in the UK, partly as an unintended consequence of the introduction of deposit insurance in 1933. In 1955, 90% of S&L's were (in theory) mutual, by 1984 over half the industry's assets were held by stock-chartered S&Ls, essentially privately-owned savings banks, as private entrepreneurs exploited the mutual form (legally and otherwise) for their own benefit, especially after the deregulation of 1980 and 1982. Subsequently, and at least in part consequently, the US taxpayer suffered huge losses of $75 billion on the deposit guarantee by the late 1980s.

Formal deposit insurance was introduced to the UK in 1979 as a subtle consequence of liberalization and a shift from structural to prudential financial regulation, leading ultimately to the establishment of the single regulator, the Financial Services Authority, for both banks and societies in 1997. Together with the changes in the mortgage and savings markets, the operational difference between banks and societies became increasingly unclear, as it had earlier in the US.

Contrary to the claim that demutualization was necessary to secure competitive advantage, conversion was driven by management, attracted by the higher remuneration and share options of the banking sector. To achieve this, they encouraged members to vote for conversion by capitalizing and distributing the reserves accumulated over a century or more, breaching the tacit understanding that these were a form of public property. Since the benefits of mutuality to savers had ceased to be obvious it was an easy matter to secure the necessary majority by the offer of a few hundred pounds.

Thus, by removing the practical distinction between shares in a mutual and deposits in a bank in the interests of a uniform scheme of regulation, deposit insurance worked to reduce the mutual sector through the expropriation of the largest financial enterprises by their own members. As for new entrants, the introduction of deposit insurance has

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in practice prevented the formation of any new building societies since 1981 and there have been no conversions the other way, from bank to mutual status. Although it may seem counter-intuitive in 2009, the introduction of deposit insurance, and now indeed an explicit or implicit government guarantee, seriously undermines mutuality.

It is not difficult to understand how this has come about. Every major failure or scandal, whether fraudulent or commercial, provokes a knee-jerk political reaction, which ratchets up the scope and extent of regulation and consumer protection. Yet it is important to distinguish two quite different approaches to regulation, structural and prudential. Structural reform over the last two centuries has on the whole been a positive force for mutuality and simple to enforce: the introduction of incorporation to give the society its own legal identity and thereby protect members from managers, the definition of different forms of society distinct from the original friendly society, the requirement to provide for good internal governance, the filing of regular information, the appointment of auditors, provision for external inspection on the request of members, etc. Its power has often rested in simple, enforceable prohibitions, such as maximum shareholdings and returns on capital, the type of business that may be undertaken and funding that may be accepted.

Structural regulation conflicts with the competitive ethos of liberalization through linking activity to legal form and creating 'fire-walls' which appear to the liberalizer as an obstacle to competion and enterprise. The change in the model of regulation was exemplified by the 1997 Building Societies Act, which switched from a regime where activities were prohibited unless permitted, to the opposite. The 1999 repeal of the US Glass-Steagall Act is a similar example of a move away from the fire-walls introduced in 1933. The converse of this switch is a move towards detailed prudential regulation of financial institutions which has become increasingly sophisticated (sic)

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with the introduction of the Basel II approach to capital adequacy. While the intention of the new approach was to promote competition and innovation at the same time as protecting the system from risk, regulators have proved no match for the larger financial institutions and have imposed an increasingly oppressive compliance burden on smaller ones, while the Basel II regime itself has proved pro-cyclical and destabilizing. The implicit acceptance by the state of responsibility for the effectiveness of this kind of regulation has led to the almost universal government guarantee of retail deposits in the face of the failure of the regulatory system in 2008. It has not escaped public notice that bank shareholders and managers have succeeded in transferring the cost of their failure to the state.

It is ironic that deregulation of the activities that may be undertaken by particular types of institution has the effect of increasing the putative degree of regulation of the institutions themselves. Yet recent events have shown that where the regulators have discretion, they are subject to capture and lose their independence of judgement, accepting rather than questioning the conventional wisdom of the regulated. In the case of mutuals, the effect of deposit insurance is to disempower membership and transfers the responsibility of governance from the 'amateur' owners to the state and de facto, to 'professional' management (meaning, in effect, no external regulation, just red tape). There is little incentive for members to devote time with a high opportunity cost, in terms either of work or leisure, to participation in corporate governance where there is neither risk of loss nor real influence on decision-making.

So, what have we lost by the breach of the principle of subsidiarity represented by deposit insurance (apart from many billions of dollars)? For one of the very few examples of a new financial mutual of any size in recent years (apart from credit unions, which have a story of their own), we can turn to the case of Shared Interest in

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the UK. Shared Interest Society Limited was the first organization of its type to be incorporated, in 1990 under legislation originally put on the statute book in 1852 by the so-called 'Christian Socialists'. In law, Shared Interest resembles a building society or credit union but differs both in its legal object and the destination of its profits. Its object can be paraphrased as to serve a borrower group by providing access to credit not otherwise available. The return on share capital invested by its members is limited in accordance with co-operative principles to "the minimum rate required to obtain and retain the capital required to carry out the object of the society". Profits in excess of that figure are distributable not to members but either to borrowers or for charitable purposes; the founders deliberately entrenched this provision to counter the long-term threat of demutualization. In other respects, the constitution is similar to any other large co-operative, notably including democratic voting (one vote per member rather than per share) and provision for active membership scrutiny.

The legal structure has important financial implications. The society is neither a bank, investment company nor charity. Investors subscribe for shares which are withdrawable at par and at the discretion of the society, not transferable and offer no prospect of capital gain. In practical terms, they resemble bank deposits but without the guarantee: a loss of capital or failure to repay on demand does not mean the society is insolvent. Each investor has a democratic vote so that, unlike a bank, the directors are accountable to the 'depositors' rather than to a separate class of shareholders. While the object of the society includes the philanthropic promotion of "wholesome, dignified and sustainable employment for the benefit of people in need", an investment is not a donation, since it can be repaid together with interest.

The commercial implications of this structure are that the society is able to provide finance for Fair Trade: unsecured trade finance to cover the costs incurred during the

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long interval of time between the start of production by a Southern producer and the ultimate sale to a Northern consumer. This form of risk-bearing quasi-equity finance cannot be provided by banks and is normally made available by commercial intermediaries, including large importers, on terms that are often oppressive to the disadvantaged producer.

Beginning with 182 members investing £239k in 1990, Shared Interest had by 2008 raised £24m from some 9,000 individual investors and was financing over 100 Fair Trade organizations. The society has historically paid a modest (below-market) rate of interest and although some bad debts have been incurred, investors have not yet suffered loss. The society received the Queen's Award for Enterprise in the Sustainable Development category for 2008. Despite its success in these terms, it faces considerable challenges in attracting further capital and is now at the point where the demand for credit far exceeds its lending capacity.

Shared Interest has no more been able to access the capital market than the borrower group it serves. Its unregulated status both permits its type of lending and excludes it from the normal financial channels. Investors have been attracted through direct advertising and word of mouth. Its uncompetitive return, reflecting the high transaction costs of this type of lending at its present scale of operations, rules out investment other than by those who identify closely with its social objectives.

The absence of external regulation exposes clearly the need for self-regulation. As with all co-operatives, the maintenance of the accountability of managers to members is a perennial challenge. Oscar Wilde is said to have described the major drawback of socialism, or any form of organization that demands a high level of membership participation, as "too many evenings". The management of some US S&Ls entrenched their positions by requiring perpetual proxies on admission to membership

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and abusing the provision to expel dissident members. By contrast, Shared Interest has established a Council of nine members as an intermediate body between the Board, which has the formal powers of management, and the membership. In principle, the Council overcomes the diffusion of ownership which is usually cited as the principal weakness of mutual governance, countered in stock companies by the (actual or potential) presence of large investors and/or the use of proxies by motivated investors.

Membership of the Council is partly organized on the Athenian or jury model, where six members are nominated at random for fixed terms of office, although they cannot be compelled to accept nomination and remain subject to election. The Council receives expenses and has powers to require information, move resolutions and call general meetings. Membership participation as measured by attendance at Annual General Meetings is high for a national society at 1.2% (2005), to which must be added unrecorded attendance at informal regional meetings around the country.

Shared Interest can be expected gradually to grow and to become more financially competitive, yet this will take decades, just like the building societies themselves in their time. Most observers view it as a worthy innovation addressing a particular form of market failure in order to relieve poverty. Yet its founders saw it as more than that: as an example of a different way of organizing the market economy, by doing business for mutual service rather than maximum return on capital. Shared Interest allows members to take controlled risks with their own money to help their fellow human beings, without seeking the maximum return: in other words, a regulator’s nightmare.

In what may seem an unholy alliance between free banking and co-operative socialism, this argument leads me to the conclusion that, since events have shown that

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the State implicitly guarantees the payments system and basic savings, that part of the system should be properly nationalized. The rest should be regulated structurally, by restoring the link between form and activity: building societies limited to savings and mortgage loans, credit unions to consumer loans, friendly societies to holding trustee investments, commercial banks to business finance, specialist mutuals like Shared Interest for their own defined purposes, etc. Depositors in private institutions, mutual or stock-chartered, attracted by higher returns than those offered by the state or by the opportunity to put their money at the service of others in some way, would do so at their own risk, without state underwriting. Most large financial institutions would have to be broken up and the role of finance in the economy would change dramatically. The benefits would be greater freedom, empowerment, diversity and innovation, not for City of London or Wall Street traders, but for citizens.

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