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From demutualisation to meltdown: a tale of two wannabe banks

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Abstract

Purpose – This paper aims to examine the influence of neoliberalist deregulation on the rash of demutualisations of the 1990s. It explores the extent to which the demutualisation of two building societies – Northern Rock and Bradford & Bingley – and their subsequent demise in the wake of the credit crunch exemplify key features of the neoliberalist experiment, with a particular focus on their post-mutualisation business models.

Design/methodology/approach – The analysis draws on literature that examines the neoliberal development of the financial sector and examines the media coverage of the financial crisis of 2007/2008 to study the discursive and material conditions of possibility for the development and implosion of the business models used by Northern Rock and Bradford & Bingley.

Findings – The paper argues that the demutualisation of Northern Rock and Bradford & Bingley was part of a broader neoliberal movement which had processes of financialisation at its centre. By converting into banks, former building societies gained greater access to wholesale borrowing, to new types of investors and to the unrestricted use of financial instruments such as securitisation. The collapse of Northern Rock and Bradford & Bingley is interpreted in the light of their access to these new sources of funding and their use of financial instruments which were either unavailable for, or antithetical to, the operation of mutual societies.

Research limitations/implications – The paper comments on the contemporary features and current effects of the 2007/2008 crisis of liquidity, whose full long-term consequences are uncertain. Further research and future events may offer confirmation or serve to qualify or correct its central argument. The intent of the paper is to provide a detailed analysis of the conditions and consequences of building society demutualisation in the context of the neoliberal expansion of the financial sector that resulted in a financial meltdown. It is hoped that this study will stimulate more critical analysis of the financial sector, and of the significance of financialisation more specifically.

Originality/value – The paper adopts an alternative perspective on the so-called “subprime crisis”. The collapse of Northern Rock and Bradford & Bingley is understood in relation to the expansion, and subsequent crisis, of financialisation, in which financial instruments such as collateralized debt obligations and credit default swaps were at its explosive centre, rather than to the expansion of subprime lending *per se*. Demutualisation is presented as a symptom of neoliberalism, a development that, in the UK, is seen to have contributed significantly to the financial meltdown.

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It has been utterly, unbelievably, astonishing. Seeing the swift disappearance of the former societies in the firestorm, which I don't claim to have predicted, has also been astonishing (Adrian Coles, Director General, Building Societies Association, quoted in Pollock, 2008a).

Introduction

Mortgages and their providers have been at the centre of the current financial meltdown. In the USA, Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation) have been placed in the conservatorship of the Federal Housing Planning Agency. In the UK, the government has intervened to nationalise or part-nationalise a number of banks, including two specialist mortgage providers: Northern Rock and Bradford & Bingley. This intervention is a significant and integral part of a much bigger national and global picture. On 8 October 2008, the UK Chancellor announced that the government would be easing problems of liquidity (and ultimately solvency) threatening the survival of the other UK banks by making available £25bn to buy preference shares (in banks) or permanent interest-bearing bonds (in building societies), with another £25bn on standby. In addition, £200bn was being made available to banks to borrow with a further £250bn of debt being offered to enable the banks to refinance their loans. At the time of writing (the end of October 2008), the ill-defined strings attached to these loans, in the form of appeals to the banks to limit executive bonuses and assist businesses, have proved to be elastic and difficult to deliver, the suspicion being that banks are using them to patch up their own balance sheets rather than to reopen flows of credit to borrowers, including businesses as well as actual and potential homeowners[1].

Northern Rock and Bradford & Bingley were, until the mid-1990s, mutual building societies[2], owned by and accountable to their members. At that time, there were over 100 independent societies. During the past 15 years, this number has diminished to around 50, mostly as a consequence of merger rather than demutualisation. A minority of societies, of which many were the largest mutuals, changed their ownership structure following a change and relaxation of regulations that began in the mid-1980s and continued through the 1990s. They converted into proprietary banks owned by and accountable to shareholders. Amongst these societies was Abbey National, which was the first to convert in 1989. It was later followed by a rash of conversions around 1997 when the Halifax, Woolwich and Alliance and Leicester converted. Today, none of these demutualised institutions exist[3]. Amongst these converters, Northern Rock and Bradford & Bingley prospered as wannabe banks as they expanded in a decade of abundant credit which fuelled a buoyant housing market where the supply of mortgages outstripped demand and competition between banks and building societies intensified[4].

In the following commentary, we explore the connection between demutualisation and the adoption of unsustainable lending practices and associated business models that, we contend, are symptomatic of global financialising frenzy and a subsequent meltdown exemplified in the seemingly limitless rise and then precipitous fall of the UK's demutualised banks. We interpret this trajectory as an outcome of a neo-liberal experiment that, in the name of individual freedom, was constructed to revive the flagging fortunes of capitalism following an extended period of stalled growth during the

1970s. What this meant in terms of post-demutualisation[5] business practice can be briefly illustrated by comments made by a senior figure who worked for one of the proprietary banks during the first half of 2007 when cautious, mutual lenders like Nationwide cut back on their loans whilst the loan books of Northern Rock and Bradford & Bingley grew to record levels:

Pulling back from the mortgage market now looks to have been a really smart bet, but we would have felt very uncomfortable with a strategy based on giving up market share and reducing lending. As it turns out, our shareholders would probably have thanked us for that approach, but we would never have risked the investor fury such a slowdown in sales would ordinarily produce (Comment from a senior figure at a PLC bank reflecting on decisions taken in the first half of 2007; quoted in Prosser, 2007).

The neoliberal revival project was sold to UK and US electorates by the charismatic political figureheads of Reagan and Thatcher, and it was sustained thereafter by the Clinton and Blair administrations. As Blair's Chancellor confidently crowed in November 1997:

I am satisfied that the new monetary policy arrangements will deliver long-term price stability, and prevent a return to the cycle of "boom and bust" (Gordon Brown, former Chancellor of the Exchequer, quoted in Finkelstein, 2008).

The neoliberal formula for reviving capital accumulation has pushed relentlessly for the sovereignty market discipline and mechanisms (e.g. stock options and bonuses) as a replacement for failed Keynesian corporatism and state regulation. The goal has been to ensure a restoration and sustained reproduction of established structures of advantage that has been accomplished, in part, through the formation of new élites (Murphy, 2008), predominantly in the financial sector where those dubbed by Keynes as "coupon clippers" have enjoyed, at least until the meltdown began in 2007, a spectacular resurgence. Central to this process was a transfer of public assets to the private sector that has been a condition and a consequence of the rapid expansion of financial activity:

Increasingly freed from the regulatory constraints and barriers that hitherto had confined its field of action, financial activity could flourish as never before, eventually everywhere. A wave of innovations occurred in financial services to produce […] new kinds of financial markets based upon securitization, derivatives, and all manner of futures trading. Neo-liberalization has meant, in short, the *financialization of everything* (Harvey, 2007, p. 33, emphasis added).

With so much finger-pointing at "reckless lending" in the subprime mortgage market as the apparent root cause of the meltdown in financial markets, it is perhaps unnecessary to say that this "everything" includes housing. What is much less evident is that mortgages, in the form of mortgage-backed securities (MBS), a form of collateralised debt obligation[6] (CDO), became a primary and highly profitable target of financial engineering. It is not simply that many people were sold loans that they would struggle to service when interest rates increased and property values stalled or fell. Rather, it is the way in which these loans were packaged up as MBSs as a basis for making further loans which, in turn, created a huge, unregulated market in credit default swaps[7] to hedge, or bet, against the risk of default on the MBSs. In the UK, a condition of possibility of such engineering was the relaxation of regulations enabling building societies to demutualise, and thereby gain increased access to wholesale markets[8]. Proprietary banks, including demutualised societies, have both greater access to, and considerable shareholder pressures to use, the wholesale markets as a means of expanding the scale and profitability of their businesses. Our commentary makes connections between "the financialization of everything" that includes home loans, the demutualisation of building societies, and the business models that relied upon the availability and reliability of sophisticated financial instruments. It is organised around three questions:

1. Why did many building societies demutualise?
2. What effects did demutualisation have upon the business models of the demutualised companies?
3. What were the key elements of the neoliberal experiment that resulted in the financial meltdown exemplified in the demise of the demutualised banks?

Why did many building societies demutualize?

The UK Building Societies Act 1986 formed part of a series of neoliberal measures intended to stimulate economic activity by increasing competitiveness through economic deregulation. In essence, the option for building societies to demutualise, which formed part of the "Big Bang" deregulation of the financial services industry, was expected to make mortgages cheaper and more widely available and further contribute to the breaking of the monopoly of building societies in the mortgage market, thereby contributing to the development of a property-owning democracy in which, in principle, everyone has a personal investment in the unhindered reproduction of the capitalist system. In the neoliberal symbolic universe, the promotion of "individual rights" functions as a central nodal point around which necessity of the preservation of strong property rights, and their protection by the state, is structured (Harvey, 2007). Neoliberalism also promotes the use of stock incentive schemes to bridge the classic dividing line between ownership and management of companies, and prioritises financial over productive capital. In this sense, the demutualisation drive that occurred in the 1990s, facilitated by an expansion of securitisation in the mortgage market (in which demutualised societies become key players), formed an integral part of a process of financialisation which, in its broadest sense, has been characterised as the "increasing role of financial motives, financial markets, financial actors, and financial institutions" (Epstein, 2006 p. 3). Notably, the demutualised societies become more fully hedged financial institutions able to wholly embrace financial motives and participate more completely in financial markets.

Before the 1986 Act, corporate governance of mutuals had relied on an "identity of interest" between lenders and borrowers. The prospect of demutualisation permitted – indeed encouraged – this connection to be severed. Why was demutualisation an attractive option? For the members of these mutual societies, there was the appeal of a substantial windfall that could amount to thousands of pounds, by signing a voting form which changed them from policy-holders into shareholders. For those who organised campaigns to demutualise the societies, there was the prospect of gaining control of considerable assets. These campaigners drew support from “carpetbaggers”[9] who invested in a society simply to be able to vote for conversion and thereby obtain windfall gains. Conservative and Labour administrations actively supported the demutualisation process. Notably, when the courts found a way of circumventing the qualifying two-year period for a member to make equity claims, intended as an anti-carpetbagger provision in the 1986 Act, the then Conservative government did not enact amending legislation to counteract this development (Tayler, 2003).

But it was not just the account holders, campaigners and carpetbaggers who sought the demutualisation of the societies. Numerous advisers and intermediaries – accountants, lawyers, investment bankers – pitched for the handsome fees for facilitating demutualisation. Finally, and most crucially, the directors of the mutuals stood to enhance their status as well as their rewards package as a consequence of conversion. For them, there was the prospect of mutating from low-profile mutual building society executive to director of a PLC bank, with the higher salary, bonuses, share options as well as the elevated status. And there was also the prospect of the pay-off accompanying acquisition by another financial institution. As Christopher Rodriques, Chief Executive of Bradford & Bingley at the time of demutualisation, is reported to have said:

When we float we are obviously responsible to shareholders and would look at any one who comes along with a large, cleared cheque (quoted in Ashton and Dey, 2008).

Bradford & Bingley's directors were actually resistant to demutualisation but proved insufficiently well prepared and organised[10], unlike the Nationwide and Britannia, to resist it. At Nationwide, in contrast, the Chief Executive led a determined campaign that lasted several years to fight off carpetbaggers (Brian Davies, Chief Executive, Nationwide; quoted in Griffiths, 2001).

Opponents of conversion were treated with derision in the popular media. Resistance by directors was interpreted as backward-looking, over-cautious and inattentive to their policy-holders, who would benefit from access to more diversified services, competitive loans and so on. As *The Times* put it, “opponents were compared to ‘steam train enthusiasts’, hopeless romantics trying to save a business model that had no place in electrified modern capitalism” (*The Times*, 2008).

In these conditions, it is not the number of conversions by the larger societies but, rather, the societies that avoided or resisted demutualisation which is remarkable, especially as those expressing doubts about the benefits tended to be publicly ridiculed. Commenting upon the demutualisation craze, an analyst of building societies for the investment bank UBS observed:

They used words like “freedom to compete” and “access to capital,” but the main reasons were excessive pay, share options and testosterone’ (John Wrigglesworth, Building Society analyst for the investment bank UBS in the 1990s; quoted in Pollock, 2008a).

This underlines a certain attraction and excitement for the stock market that does not necessarily correspond to claims of efficiency (see Stäheli, 2007). As others have argued, processes of financialisation are a medium and outcome of a neoliberal symbolic universe in which it is assumed that financial markets are the best judges of what is economically beneficial. Financial markets, Argitis and Pitelis (2008, p. 4) have suggested, may behave in a way that "their own 'beliefs' are imposed on the real economy, acting as self-fulfilling prophecy […] Financial markets […] may create their own 'fundamentals'". Companies, but also governments, then are obliged to prove their credibility according to the confidence that financial markets show in them. Conversely, when they are assessed to fail to warrant such confidence (see Gill, 1995), there is capital flight regardless of the impact upon consumers and citizens. If the flight continues, then either the company becomes bankrupt as its credit drains away, or it is rescued by the states as the lenders of last resort, as has occurred in the cases of Bear Stearns and AIG, as well as Northern Rock and Bradford & Bingley.

What effects did demutualisation have on the business models of the demutualised companies?

… the most vulnerable building societies are those that have the greatest exposure to specialist mortgages, high loan-to-value residential mortgage loans, concentration in commercial mortgage lending and recent rapid loan growth (Ferreira-Marques, 2008, referring to Fitch rating agency report on UK Building Societies, July 2008)[11].

Following the Big Bang deregulation and liberalisation of the financial services industries during the 1980s and 1990s, the market for mortgages in the UK underwent a seismic shift. From a situation where rather sleepy mutual building societies had dominated the market by providing similar, simple products on cautious terms, product offerings became more diverse and complex. Reflecting upon this period, a recent commentary in the *Financial Times* recalled how "Britain's mortgage banks changed their business model and become heavily reliant on wholesale banking and securitisation. It was a mile away from the original Friendly Society model that lent out only what the members had deposited" (Augar, 2008).

Under the Building Societies Acts of 1986 and 1997, mutuals were required to derive at least 50 per cent of funding from member deposits and to secure 75 per cent of their assets in residential property (Heffernan, 2005). This restriction opened up an opportunity for demutualised societies to increase their share of this market by making loans funded by borrowing from wholesale markets, especially during an era of abundantly cheap credit, to which the mutuals have comparatively limited access[12]. As the market mechanism kicked in, established building societies became increasingly aggressive in competing with new entrants, in the form of the banks, which now included the ex-mutuals. Products were often designed to win business from competitors by offering fixed rates and/or by lowering tariffs for the first year or more of the loan. So, in addition to the "churn" associated with the use of introductory offers developed to tempt "prime" borrowers away from their existing loan providers, there was pressure to develop ways of penetrating "subprime" sectors – that is, reaching potential customers whose employment, credit or business record had previously excluded them from entering the housing market and thus from fully reaping the rewards of participation in a property-owning democracy. At the same time, on the supply side, there was both pressure and opportunity to supplement traditional sources of finance (that is, retail deposits) by going to the wholesale markets, which during this period were often awash with money prompted, in substantial part, by the dicing, packaging and sale of mortgages as mortgage backed securities (MBS)[13] available at low rates of interest.

Intensifying competition and unparalleled growth fuelled by low interest rates and innovative products were hallmarks of the decade leading up to 2007. Responsive to shareholder pressure and executive ambition, growth was led by those demutualised societies that specialised in mortgages, notably Northern Rock and Bradford & Bingley, and by banks that had acquired or merged with demutualised societies[14]. Of these, HBOS, formed through a merger of the demutualised Halifax Building Society and Bank of Scotland, was the dominant player. When considering the rise and fall of Northern Rock and Bradford & Bingley, it is relevant to consider the fate of HBOS as its business model combined elements that they favoured – namely, reliance upon wholesale markets (Northern Rock) and/or specialisation in subprime market segments (Bradford & Bingley).

In 2006, HBOS was one of the first lenders to introduce a 125 per cent mortgage product, ostensibly tailored to young professionals who were struggling to get a foothold on the property ladder but had high future earning potential. In the same year, HBOS issued a Corporate Social Responsibility Report in which it trumpeted its record as the best performing bank stock over the past three years (HBOS, 2006). A total of 18 months later, it was ignominiously part-nationalised, with the humiliating prospect of being rescued, at a knock-down price by Lloyds TSB. In October 2008, Bradford & Bingley was described as "a busted flush, a bank that has become so dependent on the wholesale markets and a business model created around weak sectors that a merger is not only inevitable but desirable. The alternative is full nationalisation or failure" (Murden, 2008)[15].

This diagnosis of HBOS's business model and prospects echoes assessments of Northern Rock and Bradford & Bingley. HBOS is not only dependent upon wholesale money markets, as was Northern Rock and Bradford & Bingley, but was also exposed to risky housing, property and corporate lending markets, which has made it an unattractive proposition for nationalisation. At the right price, HBOS is nonetheless an appealing acquisition for Lloyds TSB, for whom the government, in order to avoid taking ownership of this sizable financial problem, was willing to bypass the merger rules which allow regulators to scrutinise and even block anti-competitive deals (Shoosmiths, 2008).

Northern Rock

At its peak, Northern Rock had become the eighth largest British bank. As 2007 arrived, it was seemingly riding high and, in June 2007 when its share price stood at 1,000p, it announced that it had sold mortgages worth £10.7bn, up 47 per cent on the same period in 2006[16]. Since its demutualisation in 1997, the Rock had grown rapidly[17] to become the fifth largest mortgage lender in the UK. It funded its aggressive expansion by heavy reliance on secured and unsecured borrowing, with about 50 per cent of its funding coming from securitization through its special purpose vehicle, Granite. Retail deposits and funds had fallen from 62.7 per cent at the end of 1997 to 22.4 per cent at the end of 2006. Despite its reliance on the wholesale sector, and as opposed to other banks, it did not insure itself sufficiently against the potential loss of liquidity (House of Commons Treasury Select Committee, 2008a). At the end of June 2007, former CEO Adam Applegarth explained its funding model, which was later called "a highly leveraged bet on interest rates" (House of Commons Treasury Select Committee, 2008b, Q 401), as follows:

We do most of our borrowing in the wholesale markets based on Libor (London Interbank Overnight Rate)[18] but most of our lending is related to base rates. Over the last five months the gap between the two has been getting steadily wider, to the extent it was 69 basis points at one stage. That means that as interest rates rise our margins get trimmed. Conversely, when they fall they flatter our margins (Adam Applegarth, former CEO, Northern Rock, quoted in Goodway, 2007).

In 2006, through a deal with Lehman Brothers, the Rock moved into subprime lending but, in contrast to Bradford & Bingley (see below), this did not become a major part of its activities. A key distinguishing characteristic of the Rock's business model was its exceptionally high level of dependence upon, and exposure to, wholesale money markets, particularly in terms of securitising its mortgages. During the first half of 2007, Northern Rock expanded its business very rapidly as its net loans to customers increased by £10.7bn during this period (House of Commons Treasury Select Committee, 2008a). Following an increase in interest rates and an associated slow-down in house price inflation, the Rock issued a profits warning on 27 June 2007. Commenting upon the position, Adam Applegarth anticipated that profit growth would nonetheless be within the company's targets of 15 per cent to 25 per cent for the second half of 2007, although more likely at the lower end of this range. He remained sufficiently confident to raise targets again in the medium term (Wearden, 2007; Attwood, 2007). And, in this, he was supported by most analysts, such as Goldman Sachs, who were, at that time, making "buy" or "hold" recommendations (Fletcher, 2007).

In early August, following BNP Paribas's decision of the 9th to suspend funds that had exposure to the US subprime market, the money markets started to dry up. At this time, Northern Rock's exposure to the wholesale market (mostly securitisation, covered bonds and unsecured wholesale funding) was 73 per cent, while the wholesale exposure of Bradford & Bingley and HBOS was 42 per cent and 43 per cent, respectively[19] (*The Telegraph*, 2007).

As the credit squeeze tightened, only the big diversified banks were able to raise wholesale funds, and they were finding it increasingly difficult and expensive. Within a week, officials at the Financial Services Agency and the Treasury alerted the Governor of the Bank of England to the effects of the credit squeeze on the Rock. On 4 September, the severity of the credit drought became evident as the Libor rose to its highest level in nine years. In similar circumstances, the European Central Bank and the Federal Reserve had moved to ease liquidity by pumping huge amounts into the banking system. In contrast, in the UK, the Governor focused upon the moral hazard of bailing out reckless lenders rather than upon the potential systemic risk associated with a reluctance to ease liquidity. This view was subsequently moderated, but not reversed, on 13 September when the Rock was granted emergency financial support[20].

The possible limitations of a business model that relied upon the wholesale money markets had actually been signalled by Northern Rock's communications director, Brian Giles, in August 2007 when he reported increasingly difficult trading conditions, though he added that “It has been a tough time in the credit markets, but we raised a lot of liquidity ahead of this turbulent period” (Brian Giles, Communications director, Northern Rock; quoted in BBC Business, 2007). A month later, the day after the Bank of England had granted it emergency funding, the Rock's share price dived by 32 per cent. In response, experts opined that “Northern Rock, which has £113bn in assets, is not in danger of “going bust’”. But customers clearly had their doubts, precipitating a run on the bank as they stampeded to withdraw their savings (BBC News, 2007). Six months later, in February 2008, Northern Rock collapsed after acquisition bids by the private sector (e.g. Virgin and Olivant) were eventually rejected by the government, and it was taken into public ownership.

Bradford & Bingley

Bradford & Bingley, formed in the mid-1960s from the Bradford Equitable Building Society and Bingley Permanent Building Society, was the UK's second largest building society prior to its demutualisation in 2000. In March 2006, the bank was valued at £3.2bn. By 20 September 2008, it was worth £256m and, like Northern Rock, it was nationalised as the government took control of the bank's £50bn mortgages, and its £20bn savings unit and branches were sold to the Spanish bank Santander which had previously acquired Abbey and Alliance & Leicester. The combined costs of nationalising Bradford & Bingley and Northern Rock have been estimated to result in every British taxpayer shouldering a burden equivalent to £5,500 in mortgage debt (Davies, 2007).

In a briefing on 21 June 2007, the CEO of Bradford & Bingley, Stephen Crawshaw, reported:

We've had an excellent start to the year marked by very strong growth. Prospects remain good for the second half as demand continues to drive the buy-to-let market. Increasing returns to shareholders through organic growth, portfolio acquisitions, and capital management will be our focus for the remainder of 2007 (Bradford & Bingley, 2007a).

A week earlier, Standard & Poor had identified Bradford & Bingley as being at particular risk from higher interest rates because it was a subprime lender (Ram, 2007). In November 2007, just two months after the run on Northern Rock, Crawshaw was reported to say that despite the market turmoil, the bank had been “resilient and resourceful" and was "now even better placed to take up opportunities in the market having disposed of its non-retail portfolios in line with its focus on retail mortgages and saving" (quoted in Murchie, 2007). It was also announced that net new lending, albeit lower than in June, was higher than a year ago and that confidence remained in the buy-to-let market (Bradford & Bingley, 2007b). Less than 12 months later, in September 2008, the bank collapsed and its mortgage book was nationalised.

Bradford & Bingley's business model comprised a number of distinctive features. It was unique in being an independent intermediary in advising on and selling other providers' mortgages in addition to its own offerings. Another feature was a propensity to diversify by purchasing businesses (e.g. estate agencies) and then selling them within a few years, often at a substantial loss. Notably, Bradford & Bingley paid £100m for the independent mortgage broker John Charcol in 2000. Four years later it was negotiating Charcol's sale for £10m. Unlike Northern Rock, Bradford & Bingley had increasingly specialised in buy-to-let and self-certified mortgages sold through its internet business Mortgage Express[21] that it had purchased from Lloyds TSB in 1997. Bradford & Bingley also bought large, risky but high-yield loan portfolios from General Motors in an attempt to increase its profitability. And in a further effort to satisfy its investors, Bradford & Bingley repeatedly slashed costs by cutting the payroll (UK Business Park, 2008).

After Northern Rock and HBOS, Bradford & Bingley was most reliant upon, and exposed to, the wholesale market for its funding, which it used to engage in riskier (e.g. sub-prime) forms of lending (Aldrick, 2008). Prior to 2007, when efforts were made to reduce its dependency, about 60 per cent of its business was funded through these markets (*The Economist*, 2008). When interest rates were low and house prices were rising apparently irreversibly, this proved to be a winning formula. In early 2006, the company's shares rose to 500p. In the first half of 2007, net lending at Bradford & Bingley increased by 92 per cent to reach a record high of £4.5bn, growth that was largely funded from the wholesale market rather than from retail deposits (*Yorkshire Post*, 2007). Pressed by the demands of its shareholders and the ambitions of its directors, notably the chief executive, this stratagem was unequivocally embraced as a "compelling route [as] the bigger banks had cornered the market in offering creditworthy borrowers the best deals" (Ashton and Dey, 2008).

From mid-2007, the buy-to-let market, usually financed with debt, was badly affected by the drying up of credit and subsequent stalling and falling of the housing market, since activity in this segment is premised upon the presupposition of rising property values and rising rents. Indeed, Bradford & Bingley warned at the beginning of June 2007 that the sector was in crisis (Property Wire, 2008). As credit tightened and the cost of loans increased, landlords fell behind with payments. Compounded by an increase in mortgage fraud in the self-certification sector, Bradford & Bingley's profits fell from £108m to £56m in the first months of 2008 compared to the same period in 2007 (Atkinson, 2008)[22]. In June 2008, there was a decline in its share price of 30 per cent. To increase liquidity Bradford & Bingley went to the market with a rights issue intending to raise £300m. This was initially priced at 82p per share but reduced to 55p, the level at which it was able to get a private equity group, TPG, to make up the shortfall by taking at 23 per cent stake. The deal with TPG then fell through as Bradford & Bingley's fortunes further deteriorated and Moody's cut the bank's credit rating[23]. Nonetheless, on the Friday before the bank's collapse and its nationalisation the following Monday when it was unable to continue funding its operations (and was nationalised), a spokesperson for the bank was reported to have insisted that:

We are fully-funded and we are one of the strongest capitalised banks in the UK. As far as the febrile speculation goes, we do not comment on market rumours (Wallop and Griffiths, 2008).

Depositors believed otherwise, as £90m was withdrawn on the Saturday morning and a further £200m was withdrawn from internet accounts by the following Monday.

To recap, for Northern Rock and Bradford & Bingley, as well as HBOS, an effect of their demutualisation was pressure to develop a business model that would produce dividends and capital growth for their shareholders:

There is a class of banks, all of them former mutuals that relied heavily on the mortgage market, Northern Rock, HBOS and Bradford & Bingley. The remaining banks have broader, more diversified, bases (BBC News, 2008).

Northern Rock was not a major player in the subprime markets compared to HBOS and Bradford & Bingley. Nor did Northern Rock diversify, for better or worse. Instead, the Rock relied very heavily upon the securitisation of its assets, in the form of mortgage-backed securities (MBSs) that in turn relied upon funding through wholesale money markets. While Northern Rock relied most heavily upon securitisation to fuel its profitable growth, securitisation was also a central plank of the Bradford & Bingley (and HBOS) funding models although, in their case, it was lending in subprime markets that contributed to their nationalisation (Bradford & Bingley) or expected takeover (of HBOS by Lloyds TSB).

What were the key elements of the neo-liberal experiment that resulted in the financial meltdown exemplified in the demise of the demutualised banks?

And then came the housing boom […] mortgage-backed securities became the hot new investment. Mortgages were pooled together, and sliced and diced into bonds that were bought by just about every financial institution imaginable. For many of those mortgage-backed securities, credit default swaps were taken out to protect against default (Philips, 2008).

An important but often overlooked condition of possibility of the financial meltdown has been the policy of the Chinese government to build up currency reserves, principally in dollars. This kept interest rates down as its dollars were then lent to the global capital markets. This supply of cheap credit fuelled subprime lending that, along with other loans (e.g. credit cards and the financing of big ticket items such as cars), inflated the debt bubble. But it was not cheap money alone that unleashed the credit binge. It was the financialisation of the debt – that is, the use of financial instruments, notably collateralised debt obligations (CDOs) in the form of mortgage backed securities (MBSs), to transmute and leverage seemingly fixed assets into liquidity that could then be used to make further loans that would again be securitised to make further loans, and so on. Financial engineering also created new risks associated with the uncertainty as to whether the obligations would be honoured, thus giving rise to the development of a further tier of instruments called credit default swaps (CDSs). Common to both types of instrument is their privately negotiated character, the absence of regulation and the lack of a central reporting mechanism to calculate their value.

CDOs involve the packaging up of assets that are sold as securities through special purpose vehicles (SPVs). A total of 50 per cent of Northern Rock's funding came through securitisation using a special purpose vehicle (SPV), Granite (House of Commons Treasury Select Committee, 2008a). SPVs enable banks to tap the capital markets by securitizing a pool of assets (mostly MBSs, in the case of Northern Rock and Bradford & Bingley) by bundling together claims to future obligations of mortgage repayments such as principal and interest (Langley, 2006). The appeal of CDOs lies in the removal of illiquid assets from balance sheets. By selling on these assets to other financial institutions, which include insurance companies and pension funds as well as other banks, banks are able to restore liquidity. This has been described as a "tower of debt" that is:

…made of the original sub-prime loans that have been piled together [at the top of this tower is the AAATranche, just below it is the AA Tranche, and so on down to the riskiest, the BBB Tranche … The banks had used these BBB Tranches] – the worst of the worst – to build yet another tower of bonds: a "particularly egregious" CDO. The reason they did this was that the rating agencies, presented by the pile of bonds backed by dubious loans, would pronounce most of them AAA. These bonds could be sold to investors – pension funds, insurance companies – who were allow to invest only in highly rated securities.

As Steve Eisman, a speculator who anticipated the meltdown and has made a huge fortune from shorting, or betting against, CDOs has commented the banks "weren't satisfied getting lots of unqualified borrowers to borrow money to buy a house they couldn't afford […] They were creating them out of whole cloth. One hundred times over! That's why the losses are so much greater than the loans" (Lewis, 2008).

The Basel I and II accords of 1988 and 2004, issued by the Basel Committee of Banking Supervision, had been intended to strengthen banks' balance sheets by requiring them to weight assets according to their risks (FSA, 2008). But this requirement has had the unintended consequence of incentivising banks to devise means of removing risks from balance sheets rather than making them more transparent. Instead of deriving most of their income primarily from the spread between the cost of their borrowing (e.g. from depositors) and their lending (to their creditors), fees and commissions from securitisation have become increasingly important. Commenting upon this development, Chick (2008, p. 121) observes that "(a) banks no longer have an on-going interest in, or capacity to monitor, the loans they make and (b) with repackaging, it is very difficult to evaluate the risk of claims on these loans".

Whereas banks once had good reason to pay close attention to the risk of their own assets, securitisation has meant that this risk passes to those who buy CDOs (see Mian and Sufi, 2008). In principle, the rating agencies evaluate these assets but they are paid to do so by the banks and they do not bear the costs if their scoring is found to be over-optimistic. For example, Standard and Poor rated Bradford & Bingley as "a strong institution with good asset quality" in September 2007[24].

It is the difficulty of evaluating the risk of claims on CDOs that has stimulated the creation of an insurance market, in the form of CDSs. To hedge against, or place a bet on, CDOs losing their value (i.e. producing negative equity for retail lenders such as home owners and for the financial institutions buying the securitized loans), financial engineers have developed instruments for mitigating this risk. JP Morgan was the first bank to introduce a CDS desk in 1994. By 2008, it was estimated to have become a $50-60 trillion market. Like CDOs are subject to infinite resale. CDSs have been famously described by Warren Buffet as "financial weapons of mass destruction" because if the insurer does not have the resources to pay the buyer, the buyer is not covered for any losses on the CDO[25].

Furthermore, the existence and size of the CDS market attracts risk speculators, such as Steve Eisman (see above). They buy CDSs for companies that they assess to have a good chance of defaulting on CDOs. Conversely, a speculator might calculate that default is highly unlikely and therefore obtain and sell a CDS in the expectation that premiums will be collected with minimal chance of having to pay out on insurance claims. Bear Stearns and AIG had trillions of dollars of CDSs on their books, leaving their trading partners exposed to their possible default – which is what explains the swift intervention of the Federal Reserve to limit the damage by issuing loans which these companies have been required to service at a premium rate. This might seem rather irrelevant in relation to the fortunes of UK demutualised building societies, but CDSs are written on subprime mortgage securities. As Shah Gilani has commented:

It's bad enough that these sub-prime mortgage pools that banks, investment banks, insurance companies, hedge funds and others bought were over-rated and ended up falling precipitously in value as foreclosures mounted on the underlying mortgages in the pools. What's even worse, however, is that speculators sold and bought trillions of dollars of insurance that these pools would, or wouldn't, default. The sellers of this insurance (AIG is one example) are getting killed as defaults continue to rise with no end in sight (Gilani, 2008).

The fate of the demutualised UK banks has been sealed by the loss of confidence in the markets for CDOs and CDSs that has produced a *volte face* by banks as, in an effort to shore up their balance sheets, they have hoarded cash, including that made available to them by central banks. A preoccupation with their liquidity has been prioritised above making loans to the likes of Northern Rock whose business model, with its extreme reliance upon securitization, was assessed to be ill-equipped to survive a downturn. When the market for securitisation dried up in the wake of the so-called “subprime crisis” – a crisis which, we have suggested, is better understood as a crisis of the financialisation dominated by the explosive growth of (now toxic) CDOs and CDSs – exposure to the risks associated with these instruments has led banks to retain their assets in order to preserve liquidity and avoid insolvency. Those wannabe banks – Northern Rock, Bradford & Bingley and also to a lesser degree HBOS – have been unable to transform their highly illiquid assets into the cash required to fund their ongoing business. When they have not collapsed and been nationalised, they have been rescued and propped up by government loans in the form of preference shares. In contrast, the business models favoured by proprietary companies were simply off-limits to mutual building societies, which are subject to guidelines and monitoring by the FSA to meet targets of liquidity[26].

Conclusion

The best argument for mutuality is blindingly simple – a building society is owned by its savers and borrowers, so its sole purpose is to serve them. That goal is not complicated by a conflicting need to satisfy the Square Mile (Sutherland, 2008)[27].

Our central thesis has been that the key to understanding the current financial meltdown is not the rapid evaporation of cheap credit, popularised as the “credit crunch”, but the rise of financial instruments, in the form of CDOs and CDSs, that have been used to supercharge the borrowing process. Notably, high-risk, “subprime” loans on big ticket items, such as homes, have been securitised to remove them from lenders' balance sheets. In a highly detailed analysis of the role of securitization in the rise of home loans in the USA from 2001 to 2005, Mian and Sufi (2008, pp. 22-3) conclude that:

The process of mortgage originators selling and securitizing loans led to a sharp shift in the supply of mortgage credit. The expansion of supply affected sub-prime customers who were traditionally marginal borrowers unable to access the mortgage market […] The changes caused a subsequent spike in default rates, which have in turn depressed the housing market and caused financial market turmoil.

The rapid expansion of derivatives (e.g. mortgage-backed securities) marks a shift to “profit from betting on market chance, rather than growth, which has made financial innovation a primary driver of the expansion of financialization into ever-increasing areas of social organization” (Montgomery, 2006, p. 305). As we noted earlier, Northern Rock's business model was characterised as “a highly leveraged bet on interest rates”. Derivatives have grown to become a central feature of a financialised global economy in which “downturns are now likely to result from a loss of confidence in the equity market rather than from inflation in the goods market, rapid credit growth over investment, and financial imbalances become all important” (Aglietta and Breton, 2001, p. 434). Economic crisis now stems from unpaid debts because accumulated capital does not require the prior settlement of debts. Bradford & Bingley's and especially Northern Rock's highly geared business models illustrate this point. Thus, the current financial crisis is essentially a crisis and consequence of financialisation as such (see also Blackburn, 2008).

It is questionable, however, whether the directors of these demutualised companies could be expected to adjust rapidly and successfully to a very different financial terrain from that encountered by mutual building societies. It has been suggested that:

… the individuals running these banks ran slap bang into financialization in its pomp. “Originate and distribute” banking was all the rage. The investment bankers claimed to have “transformed risk” through their credit derivatives, off-balance sheet vehicles and securitizations. Governments and regulators were easing off the brakes in respect of capital adequacy, disclosure and intervention. Hedge funds moved shareholder activism from a minority pursuit practiced by maverick raiders to a mainstream activity and companies could not afford to slip. Benign economic conditions and low interest rates encouraged leverage and risk-taking (Augar, 2008).

Beholden to shareholders who prioritised dividends and profitable growth, the demutualised banks were under great pressure to meet these demands. The stratagems devised by Northern Rock and Bradford & Bingley were highly successful in relieving this pressure, at least in the short-to-medium term. They were compelled to keep issuing home loans funded by the wholesale markets and, in Bradford & Bingley's case, further increased its already high exposure to the subprime segment at a time when the mutuals and more diversified banks (e.g. HSBC, Barclays, Lloyds TSB) had the luxury of opting to cut back on their mortgage business. Reflecting upon Nationwide's decision to restrict the issuing of loans in anticipation of a stalling in house price inflation, its retail director, Stuart Bernau, stated that “we took the view at the beginning of this year [2007] that our rivals were driving down pricing, loosing affordability constraints and sacrificing quality for market share” and went on by emphasising the importance of sticking to a “very basic principle despite losing market share, in the light of these developments” (Prosser, 2007). Astute investors in Northern Rock and Bradford & Bingley would have realised that the business models developed by these banks were products of expediency and opportunism that could not be sustained when interest rates increased and/or credit tightened. What was more difficult to anticipate without a working knowledge of the role of securitisation was the speed at which these businesses would be enveloped and then wiped out in the turmoil of the meltdown.

In periods of high liquidity in money markets, mutuals' restricted access to these markets makes it more difficult for them to compete with banks, although this handicap is compensated by the absence of shareholders demanding dividends and/or capital gains and the associated threat of hostile takeover bids. When liquidity tightens or freezes, mutuals are much less exposed – in two respects. First, their capped reliance upon wholesale money markets inhibits involvement in the sale of subprime mortgages, so their asset base is comparatively protected. Second, when capitalism enters one of its periodic bouts of crisis and panic, mutuals continue in business because their primary source of funds is from retail savers, not the money markets. Indeed, during these periods savers tend to turn to the mutuals precisely because their business model is, like the steam railway, immune to high-voltage power failures. Over and above these considerations, the primary obligation of directors of these societies is to their policy-holders who are generally risk-averse, passive and to a degree “locked in”. Mutuals are not beholden to footloose shareholders and speculators who, if they are sufficiently shrewd, are alert to the limitations of business models that are capable of delivering strong performance only while conditions allow.

Where dark clouds form, there is usually a silver lining. In this case, it is the mutual building societies that have profited from the meltdown of financial markets. Even for those, like Cheshire, Derbyshire and Barnsley Building Societies, that have encountered difficulties with their loan books, there has been a ready refuge in larger societies, such as the Nationwide and Yorkshire. In general, mutual societies that had been declared marginal, if not dead, in the wake of the demutualisation wave of the 1990s have been the principal beneficiaries of the financial turmoil. As a pertinent indicator of resurgence of the mutuals, in the first half of 2008, they received almost double the amount of deposits (£6.3bn) that had been taken in the first half of 2007 (*The Telegraph*, 2008).