

# MYNERS REVIEW OF THE GOVERNANCE OF LIFE MUTUALS

## Response by The Building Societies Association

### Introduction

1. The Building Societies Association is the representative trade body for all the UK's 63 building societies. These societies have total assets of over £230 billion, around 15 million adult investing members and over 2.5 million borrowing members. Building societies account for just under 20% of residential mortgage loans, and retail deposits, outstanding. Building societies operate through around 2,100 branches and, including their subsidiaries, employ over 40,000 staff.
2. The Association currently collects a range of data on, and promotes good practice in, building society corporate governance issues. Appendix 1 summarises the Association's activities in this area.
3. This response reproduces the questions in the consultation document published by HM Treasury in July 2004, and gives the Association's views on the points raised. Neither building societies nor the Association have sufficient experience of the mutual life industry to answer all of the questions – indeed, some questions can be answered only by the mutual life offices themselves. However, the Association has answered some of the questions directed at the life offices because of the Myners terms of reference which require it to consider, and make recommendation on, the wider mutual sector. Furthermore, **in giving its experience of the various corporate governance issues raised by Myners, the Association is not suggesting that mutual life offices should automatically follow the procedures adopted by building societies.** Some of the recent innovations of building societies are worthy of consideration by mutual life offices and by the Myners Review team, but no more than that. The differing nature of financial mutuals means that some of the arrangements that work well in building societies may be inappropriate in other contexts.

### **Q1. To what extent does the current guidance on corporate governance, particularly the Combined Code, provide an appropriate framework for mutual life offices? Would another approach be more effective?**

4. The Association considers the Combined Code provides an appropriate framework for the corporate governance of building societies, although some guidance on the application of the Combined Code is needed to reflect factors such as the lack of institutional investors. Accordingly, the Association will be issuing guidance on the Combined Code to societies shortly. (This is attached as Appendix 2.) The Association considered whether another approach – perhaps a Code written specifically for building societies – might be more effective, but took the view that recent thinking on corporate governance, most notably the Higgs Report, was not, in its essence, restricted to the corporate governance of plcs but, with the appropriate tailoring, was applicable to other corporate entities. Similarly, it appears that the Combined Code and the Higgs Report have provided one of the bases of the thinking of the Review Group on the corporate governance of co-operative societies initiated by the trade association for co-operative

societies, Co-operatives UK. A number of building societies have already adopted the Combined Code as the basis for their own corporate governance.

**Q2. What is the best way of securing mutual life offices' compliance with corporate governance best practice?**

5. The same way as for plcs. The arrangements applying to plcs in respect of the Combined Code do not demand compliance, but rather are operated under the “comply or explain” philosophy; that is, the Combined Code is not expected to be applied in every respect by every company. Where application would result in a less than optimum outcome in relation to the particular circumstances of an individual company the company is entitled to explain why it is taking a different approach. However, among the options for ensuring that mutual life offices either comply or explain are the following –

- (a) Enforcement of the relevant requirements (however expressed) by the Financial Services Authority, although it is understood that the FSA does not do this for plcs in its role as the Listing Authority.
- (b) Transparency of compliance or explanation in reports to members and the media, leaving enforcement to member, media, credit rating agency, market and peer group pressure.
- (c) Assessment of compliance by the firm's external auditor.
- (d) Assessment of compliance by a relevant trade association (as is the case of the current code on corporate governance in UK co-operative societies).
- (e) Assessment by an independent non-statutory body, in the same way as, for example, compliance with the Banking Code by banks and building societies is assessed by the Banking Code Standards Board. (This body is funded by banks and building societies, but has a majority of directors independent of the financial services sector.)

6. The Association does not believe that (a), (d) or (e) are practicable. A combination of (c) and (b) appears to work well in the plc sector, and is becoming the norm in parts of the mutual sector where, for building societies, there is also formal encouragement from the FSA for societies to have regard to the Combined Code (the FSA's interim prudential sourcebook for building societies refers). A company's annual report will contain a statement from its auditors if it is not compliant with the Combined Code and offers no explanation. This will then result in attention to the issue from a wide range of stakeholders in the company. A similar process occurs when the explanation offered by the company is implausible. We consider similar arrangements already work well for the growing number of building societies that follow the Combined Code and would also be effective for mutual insurers – and other financial mutuals.

**Q3. In your opinion should the ownership structure or the nature of the business conducted by a life mutual affect the composition or structure of its board? If so, how?**

7. Clearly the nature of the business conducted by an organisation should affect the composition of the board. Different lines of business require different expertise at board level.

8. The ownership structure of any mutual should not necessarily be reflected in the composition of its board. The skills of board members, and of the board collectively, are much more important. Nevertheless members of the boards of mutuals need to be aware of -

(a) The differing nature of the relationship (in a mutual and a plc) between the board and those to whom it is accountable – individual members rather than institutional shareholders.

(b) The differing financial objectives in mutuals compared to plcs – many mutuals for example seek to narrow margins in order to give consumers a better deal rather than widen them in order to deliver dividends to shareholders.

(c) The social responsibilities which many mutuals take upon themselves.

**Q4. In your experience, is the information and advice (including actuarial advice) used by the non-executive directors of life mutuals sufficient – in terms of quality and relevance – to enable them to exercise effective oversight of the executive? In what ways might it be improved? If more information and advice is needed what are the resource implications? Do similar issues arise for the non-executives of other complex businesses, such as wholesale banking or science-based businesses?**

9. The Association does not have the expertise to answer this question in the context of a life business. Building societies have revised their board structures in recent years to cope with the growing complexity of their businesses. Risk committees have become more common, audit committees have taken on greater responsibilities and induction and training regimes are much more intensive than used to be the case.

**Q5. What is the role of the non-executive director in a complex or technical business? In particular what is their capacity to understand and to challenge the executive over technical aspects of the business?**

10. The capacity of non-executive directors to challenge the executive depends on the quality, skills and experience of the non-executive directors. Most building societies have recruited directors with expertise in the areas of business in which the society operates. The need for such expertise has grown as the environment in which societies operate has become more complex, due, not least, to the introduction of new regulatory requirements. Moreover, where societies have expanded into new spheres they have tended to recruit non-executives with experience of the new business areas in order to challenge the executive. As noted above, training is available to non-executives in

complex areas, and directors are able to obtain independent advice at the society's expense where necessary, as provided for in the Combined Code.

11. In addition, it is often not necessary for directors to go into the minutiae of the detailed technical matters dealt with by the executive in complex areas; rather at least some non-executive directors should be asking broader based questions about the impact of complex or technical issues on the overall strategy of, and risks faced by, the business.

12. Having commented briefly on the role of the non-executive director, the Association wishes to stress its belief in a unitary board; the legal responsibilities of all directors are identical, although their roles on a board may differ.

**Q6. What can the owners of a complex or technical business reasonably expect of its non-executive directors? How would you characterise the practical limitations of a non-executive director? What steps might be taken to codify what is reasonable and realistic in this context? Should executives and non-executives have the same legal duties to the company?**

13. The Association has no further views on the questions raised in this area, beyond the points raised in answer to Q5 above.

**Q7. What roles should policyholders play in the running of mutual life companies? Are there practical barriers to policyholder participation in the UK life mutuals? What action would be needed to allow more effective engagement?**

14. Attached, as Appendix 3 to this submission is a copy of the Association's paper entitled *Listening to Members - the Building Society Sector Experience* which demonstrates the steps being taken by building societies to promote effective engagement with their members. The Association is not sufficiently knowledgeable about current policyholder participation in UK life mutuals to be able to analyse the practical barriers that might exist in this sector. The decision by many building societies to engage much more seriously with their members than previously was probably driven, to some extent, by the carpetbagging and demutualisation experience of the late 1990s.

15. In the same way as shareholders in plcs are not involved in the day-to-day operations of their company, members of building societies are not involved in the detailed "running" of the society. However, in a broader sense members have a significant input into the overall approach taken by the society. The mechanisms described in Appendix 3 are generally designed to facilitate processes of consultation; the results of that consultation can certainly have an impact on the way the society operates, in some cases at a detailed level, and on its approach to various policy issues. Nevertheless, management must undertake the day-to-day "running" of the organisation

**Q8. Lord Penrose says that in a life mutual "..... it is the policyholders who are the source of the risk capital for the enterprise" (Chapter 20, paragraph 51).**

**What does this mean for the relationship between a mutual life office and its policyholders?**

16. A similar comment could legitimately be made about building societies, where members are the source of “risk” capital for the enterprise – although much of the capital in a building society (and in a life mutual) will have been built up by previous, rather than current, members. Capital is held in a building society to cover the various risks that are taken by a business involved in lending – the credit risk that the borrower will not repay, the interest rate risk inherent in the balance sheet, operational risks etc. However, it should be noted that the nature of the business run by most building societies means that the “risk” run by members of societies is extremely low. Every society has capital well above the minimum specified by the international agreement on banking sector capital known as “Basel 1”; no ordinary investor in a building society has lost any of their savings since at least 1945, and - so far as we are aware - for a long time before that.

17. A proposal by a building society to spend more than 15% of the capital of the organisation on an acquisition or investment outside the society’s mainstream business would require approval by members in a general meeting - although it should be noted that this legislative provision has never been used. Accordingly, members – to the extent that they are prepared to exercise their right to vote – have a say in the investment of any significant proportion of the risk capital. A similar approach might have merit in the life mutual sector.

18. The board of a mutual is responsible to members in two ways – as customers and owners. In contemplating developing the business a board needs to bear both relationships in mind.

**Q9. Lord Penrose acknowledges that the FSA’s work since 1997 “..... has sought to anticipate many of the lessons that might be drawn by this enquiry, and it should come as no surprise that it has largely succeeded in that.” (Chapter 30, paragraph 3). In so far as corporate governance is concerned, do you agree?**

19. The Association is insufficiently aware of the regulation of life mutuals to comment on this issue.

**Q10. Is there a further role for the FSA to play in approving firms’ corporate governance?**

20. As the Association has indicated in the response to Q2 above, the FSA could be given a role in securing mutual life offices’ compliance with corporate governance best practice. The FSA already promulgates a short ‘sample’ Code of Governance for building societies which it inherited from the regulator for building societies before the Financial Services and Markets Act was implemented (the Building Societies Commission). This Code is, however, fairly limited.

21. The FSA encourages building societies to “have regard to” the Combined Code and the forthcoming BSA guidance, referred to earlier, is intended to assist societies in this area.

**Q11. Listed companies are subject to the influence of their shareholders, particularly large shareholders and the risk of takeover. What market forces are made relevant for mutual life offices? How effective are they in promoting good performance and how might they be enhanced?**

22. There is plenty of academic literature questioning the received view that shareholders typically have significant influence over listed companies. Many institutional shareholders do not vote at company annual general meetings and there is little shareholder activism at many companies. Few, if any, institutional shareholders contact the ultimate owners of the shares to determine their views on company issues. Indeed it is not clear to whom institutional shareholders are themselves accountable. Too often in the debate between corporate governance standards in mutuals and plcs the comparison is made between perfectly functioning plcs and poorly functioning mutuals. There is a risk that Q11 falls into this trap.

23. The threat of demutualisation has shown that building societies are subject to the risk of takeover and, as noted above, this has affected their performance. The Association is insufficiently aware of the precise nature of the threat of demutualisation to life offices to be certain of the extent to which that threat might influence their behaviour.

24. Societies are also influenced by market forces – they decline in size, or grow only slowly, if they do not offer the savings accounts and mortgages which the market demands. The rating agencies, the media, including a vigilant personal finance press and a number of influential web sites, and the FSA exert considerable external pressure on societies.

25. While, arguably, “listed companies are subject to the influence of their shareholders” they are less subject to the influence of their customers than are many mutuals. It is not clear that some of the branch closure programmes, executive pay packets, and approaches to service and product provision and pricing that some banks have implemented in recent years would have occurred had the directors of these institutions been accountable to their customers in the same way as directors of building societies are.

**Q12. Do specific barriers exist to the success of mutual businesses in the UK? If so, how might they be addressed?**

26. The main potential barrier to the continued success of building societies is the legislation which defines their nature – the Building Societies Act 1986, as amended. The legislative requirements are currently consistent with market requirements; however if the legislative definition of a building society – that it raises at least 50% of its funds from individual members and makes at least 75% of its “business assets” on

the security of residential property – becomes inconsistent with market realities, that legislation would be a barrier to the success of societies unless it was changed. In the past the authorities in the United Kingdom have shown a significant willingness to amend the legislation; it is hoped that this will continue. The Miles Report on long-term fixed rate mortgages made a number of recommendations for change in building society legislation which HM Treasury (as the relevant department) is presumably analysing.

27. The Association's knowledge of mutual life businesses is limited and we are not aware of any specific barriers to the success of that sector.

**Q13. What are the forces that drive demutualisation? What are the implications of demutualisation for members and customers?**

28. Linking with Q12, in theory, the main economic force driving demutualisation is the perceived need for capital, although none of the building societies that demutualised in the 1990s raised new capital when they demutualised. Indeed, Halifax plc returned capital to shareholders soon after it demutualised. It is difficult – but not impossible – for mutual organisations to access external capital. Building societies have been able to issue permanent interest bearing shares (tier one capital in Basel terminology) and subordinated debt (tier two capital). There are, however, limits on the amount of capital of this type that can be counted within the Basel definitions. Institutions which have their own shares traded on the market can more readily acquire other institutions – for example by “printing” more shares if the market values these. Mutuals acquiring other businesses normally need to pay cash.

29. A number of commentators have found that a central consideration of boards and senior executives which opt for demutualisation is their own well-being. Typically salaries and fees in institutions that have demutualised are higher than in the predecessor mutual organisation. Share option packages paid in the plc sector are lucrative, and add to the personal incentive of directors and senior management to convert.

30. Finally a major force driving demutualisation has been the payment of windfalls to members of mutuals. It is questionable whether the votes required under building society legislation to confirm a board conversion proposal would have been achieved without the associated payment by the mutual of large sums of money to the membership.

31. Moving on to the second part of Q13, members and customers are typically worse off as a result of demutualisation in the medium to long term because shareholder owned organisations need to deliver a stream of dividends to their investors. In the context of a building society that converts to a plc, this requires either higher mortgage rates or lower savings rates than would have been the case had it remained a mutual. Examination of the accounts of converted building societies shows that total management expenses plus dividend payments are typically 35% higher than management expenses only. The accounts also show that for comparable business the

margins under which most converted institutions operate are wider than those of the largest building societies.

32. Commitment to local communities through branch networks also seems to decline following demutualisation. In the five years from 1995 to 2000 the converted mortgage banks that were once building societies closed about 25% of their branches. The equivalent figure for the remaining mutual societies was 2.5%.

33. There is also research evidence suggesting that consumers have a higher degree of trust in mutuals compared to non-mutuals. Accordingly one would expect levels of trust in financial institutions – a factor perceived as influencing the overall levels of savings – to decline if mutuals decline in importance.

**Q14. What specific governance arrangements currently apply to other financial mutuals? In what ways do their governance arrangements differ from those that apply to life mutuals? Which, if any, of the options for life mutuals could be applied more widely in the financial mutual sector? What would the consequences be?**

34. Answering the first question within this section, building society legislation requires societies to operate on a one-member one-vote basis. Accordingly, all investing members with more than £100 to their name and all borrowing members with £100 or more indebtedness have the right to receive certain information on the operation of their society – in particular, a summary financial statement – and the right to vote at annual and special general meetings on the composition of the board and on any special or ordinary resolutions that might be put forward for debate. Members also have the right to propose resolutions at General Meetings, and to nominate individuals to stand for election to become directors.

35. Attached to this submission is a copy of the Association's leaflet - *Your Rights as a Member of a Building Society* - which provides further information. This information sheet is available on the Association's web site - [www.bsa.org.uk](http://www.bsa.org.uk) - and is also distributed to interested building society members.

36. As far as we know, building societies are the only financial mutuals currently arranging for the circulation of information, and voting, on directors' remuneration. Currently building society legislation requires societies to include details of directors' fees in their annual reports. However, only a relatively small proportion of members request a copy of the annual report. In 2004 38 of the 63 building societies included at least some details of directors' remuneration and the policy behind its determination in their summary financial statement – which goes to all members with savings, or a mortgage loan, of £100 or more. These societies account for more than 95% of the total membership of all building societies. Also in 2004, 18 societies, accounting for more than 90% of the total membership of all building societies, held an advisory vote on their directors' remuneration reports (as is required in the quoted sector). It is anticipated that both of these figures will rise in 2005. It is the Association's policy to

encourage societies to distribute information, and hold advisory votes, on directors' remuneration reports.

37. As noted in the answer to question 2 the Association will shortly be promulgating guidance on the Combined Code to building societies.

38. The Association is insufficiently aware of the governance arrangements that apply to life mutuals to be able to compare these arrangements with those of building societies. It is important to note, however, that while building society legislation ensures that the basic features of the corporate governance of societies is identical across all societies, there are, it seems to the Association, a wide range of practices in the mutual life office sector.

**Q15. Do small affinity group-based mutual life firms face different governance issues from the largest firms in the sector?**

39. It is likely that this is the case. Building societies range from small institutions with no branches and balance sheets of under £20 million to £multi-billion organisations with thousands of staff and hundreds of branches. The Combined Code in the plc sector makes it clear that some of the requirements of large plcs are not applicable to smaller plcs; this will also be reflected in the corporate governance arrangements of other organisations.

**Q16. Are you aware of effective governance regimes for life (or other) mutuals in other countries? Is this a result of a formal (regulatory or government) requirement or is it voluntary driven by the industry? Are there aspects of the arrangements in other countries that would be desirable and practical to adopt in the UK?**

40. The Association is currently researching this issue and hopes to submit a supplementary paper before the end of September 2004.

**Conclusion**

41. Building societies take corporate governance issues extremely seriously. The Association believes that the action that building societies and the Association have taken over the last few years have significantly improved the standards of corporate governance in societies and that these bear critical comparison with standards in the plc sector.

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## **Appendix 1 to the BSA response to the Myners Review Consultation Document**

**This Appendix summarises the information on building society corporate governance which is communicated by the BSA to its members, the 63 building societies based in the UK.**

### **Regular communications**

Consistent with the BSA's encouragement of societies to adopt good standards of corporate governance, the Association issues to building societies regular information on matters relating to societies' corporate governance. The subjects covered are as follows:

- Remuneration of senior building society board members: an annual review of the remuneration received by all building society chief executives, finance directors and chairmen.
- AGM turnout and voting figures: an annual summary of turnouts and votes - including voting on directors' remuneration - by building society members at society annual general meetings.
- Characteristics of building society boards: an annual analysis of the composition of building society boards – including profiles by age, gender and length of service of directors; and size of board.

### **Guidance**

The following guidance is produced by the BSA to assist building society directors in carrying out their duties.

- Corporate Governance: Guidance for Building Societies – the BSA is close to finalising guidance to building societies on the Combined Code on Corporate Governance, which societies will be encouraged to follow. The Association will monitor the extent to which societies follow the guidance.
- BSA Guide for Directors and Managers: This is a handbook providing a birds-eye-view of many of the topics with which new directors of building societies need to become familiar, as well as providing background information on the financial services industry for those directors who may be new to it.
- BSA Guidance on the Preparation for and Conduct of General Meetings, Including Annual General Meetings: this is a good practice guide, produced by the Association mainly to assist smaller building societies.

More generally, the BSA informs building societies of wider developments in corporate governance best practice which are not directly relevant to societies. (A recent example

of this was the DTI proposals for listed companies to include an operational and financial review in their annual reports.)

### **Other Publications**

BSA Listening to Members Report: this report highlighted the various ways in which building societies engage with their owners – individual building society members.

### **Seminars and conferences**

The following regular events include consideration of building society corporate governance matters.

- The BSA Annual Conference has in recent years included a session on corporate governance.
- The Association holds an annual seminar for new non-executive directors (NEDs) of building societies and, separately, an annual seminar for existing NEDs and an annual seminar for building society chairmen. At all these events corporate governance issues are high on the agenda.
- BSA annual mutuality conference: this features corporate governance issues particular to mutuals.
- BSA seminar for chairmen of building society audit committees.
- Regional conferences: two of the regional associations that comprise the BSA hold annual conferences and there is a separate annual conference for smaller societies. At all these events corporate governance issues have featured prominently in recent years.

BSA 17 September 2004

## Appendix 2 to the BSA submission to the Myners Review of the Governance of Life Mutuals

### The Combined Code on Corporate Governance: BSA Guidance for Building Societies

#### Introduction

A revised Combined Code on Corporate Governance was issued on 23 July 2003 and applies to reporting years beginning on or after 1 November 2003. The Combined Code is addressed to publicly quoted companies. As such, building societies do not have to comply<sup>1</sup>.

The FSA's Interim Prudential Sourcebook for Building Societies (IPRU(BSOC)) states that building societies 'should have regard to the Combined Code when establishing and reviewing their own corporate governance arrangements' (section 3.2.2 G of IPRU(BSOC) refers). In addition, societies are 'encouraged to adopt' the sample Code of Governance which is set out in Annex 3A to Chapter 3 of IPRU(BSOC).

This guidance is intended to assist building societies in having 'regard to' the Combined Code. It does not prescribe any particular course of action. Nor is the Combined Code itself prescriptive. Rather, it follows a 'comply or explain' approach, whereby publicly quoted companies are encouraged to comply with the Combined Code and, where applicable, to explain in their annual report why they have not complied with a particular provision.

This guidance for building societies follows a 'by exception' approach, in that it refers only to those elements of the Combined Code which are either not considered to be relevant to building societies, or which raise particular issues for building societies considered worthy of discussion. The guidance is in the form of text boxes, such as this one, inserted within the relevant sections of the Combined Code.

The FSA has been consulted about the development of the BSA guidance, and welcomes this initiative on the part of the BSA. The FSA expects that the BSA guidance will be helpful in identifying the issues to be considered by building society boards when seeking to apply the latest version of the Combined Code to the different circumstances of a building society, and to their particular society. In some parts the BSA guidance suggests alternative approaches to those set out for listed public companies in the letter of the Combined Code. The FSA is content that societies following the BSA guidance demonstrate that they have had regard to the Combined Code when establishing and reviewing their corporate governance arrangements, as encouraged by the FSA's own high level guidance at IPRU (BSOC) Vol 1 Chapter 3, 3.2.2 G.

The Building Societies Association  
September 2004

The Combined Code is reproduced by kind permission of the Financial Reporting Council.

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<sup>1</sup> Although building societies that have issued PIBS are subject to the FSA Listing Rules, to which the Combined Code is appended, the Combined Code itself does not apply to PIBS-issuing societies. This is because the relevant Rule, Rule 12.43, which requires a listed company to state in its annual accounts how it has applied the principles of the Combined Code, does not apply to issuers of PIBS.

**THE COMBINED CODE ON  
CORPORATE GOVERNANCE**

**July 2003**



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## **CODE ON CORPORATE GOVERNANCE**

### **PREAMBLE**

1. This Code supersedes and replaces the Combined Code issued by the Hampel Committee on Corporate Governance in June 1998. It derives from a review of the role and effectiveness of non-executive directors by Derek Higgs<sup>1</sup> and a review of audit committees<sup>2</sup> by a group led by Sir Robert Smith.
2. The Financial Services Authority has said that it will replace the 1998 Code that is annexed to the Listing Rules with the revised Code and will seek to make consequential Rule changes. There will be consultation on the necessary Rule changes but not further consultation on the Code provisions themselves.
3. It is intended that the new Code will apply for reporting years beginning on or after 1 November 2003.
4. The Code contains main and supporting principles and provisions. The existing Listing Rules require listed companies to make a disclosure statement in two parts in relation to the Code. In the first part of the statement, the company has to report on how it applies the principles in the Code. In future this will need to cover both main and supporting principles. The form and content of this part of the statement are not prescribed, the intention being that companies should have a free hand to explain their governance policies in the light of the principles, including any special circumstances applying to them which have led to a particular approach. In the second part of the statement the company has either to confirm that it complies with the Code's provisions or - where it does not - to provide an explanation. This 'comply or explain' approach has been in operation for over ten years and the flexibility it offers has been widely welcomed both by company boards and by investors. It is for shareholders and others to evaluate the company's statement
5. While it is expected that listed companies will comply with the Code's provisions most of the time, it is recognised that departure from the provisions of the Code may be justified in particular circumstances. Every company must review each provision carefully and give a considered explanation if it departs from the Code provisions.

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<sup>1</sup> "Review of the role and effectiveness of non-executive directors", published January 2003.

<sup>2</sup> "Audit Committees Combined Code Guidance", published January 2003.

6. Smaller listed companies, in particular those new to listing, may judge that some of the provisions are disproportionate or less relevant in their case. Some of the provisions do not apply to companies below FTSE 350. Such companies may nonetheless consider that it would be appropriate to adopt the approach in the Code and they are encouraged to consider this. Investment companies typically have a different board structure, which may affect the relevance of particular provisions.
7. Whilst recognising that directors are appointed by shareholders who are the owners of companies, it is important that those concerned with the evaluation of governance should do so with common sense in order to promote partnership and trust, based on - mutual understanding. They should pay due regard to companies' individual circumstances and bear in mind in particular the size and complexity of the company and the nature of the risks and challenges it faces. Whilst shareholders have every right to challenge companies' explanations if they are unconvincing, they should not be evaluated in a mechanistic way and departures from the Code should not be automatically treated as breaches. Institutional shareholders and their agents should be careful to respond to the statements from companies in a manner that supports the 'comply or explain' principle. As the principles in Section 2 make clear, institutional shareholders should carefully consider explanations given for departure from the Code and make reasoned judgements in each case. They should put their views to the company and be prepared to enter a dialogue if they do not accept the company's position. Institutional shareholders should be prepared to put such views in writing where appropriate.
8. Nothing in this Code should be taken to override the general requirements of law to treat shareholders equally in access to information.
9. This publication includes guidance on how to comply with particular parts of the Code: first, "Internal Control: Guidance for Directors on the Combined Code"<sup>3</sup>, produced by the Turnbull Committee, which relates to Code provisions on internal control (C.2 and part of C.3 in the Code); and, second, "Audit Committees: Combined Code Guidance", produced by the Smith Group, which relates to the provisions on audit committees and auditors (C.3 of the Code). In both cases, the guidance suggests ways of applying the relevant Code principles and of complying with the relevant Code provisions.
10. In addition, this volume also includes suggestions for good practice from the Higgs report.

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<sup>3</sup> "Internal Control: Guidance for Directors on the Combined Code", published by the Institute of Chartered Accountants in England and Wales in September 1999.

11. The revised Code does not include material in the previous Code on the disclosure of directors' remuneration. This is because "The Directors' Remuneration Report Regulations 2002"<sup>4</sup> are now in force and supersede the earlier Code provisions. These require the directors of a company to prepare a remuneration report. It is important that this report is clear, transparent and understandable to shareholders.

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<sup>4</sup> The Directors' Remuneration Report Regulations 2002, S.I. no.1986

Although the Directors' Remuneration Report Regulations do not apply to building societies, the BSA encourages societies to disclose their directors' remuneration policy on an equivalent basis. (BSA Circular No 6108 of 29 July 2004 refers.)

# **CODE OF BEST PRACTICE**

## **SECTION 1 COMPANIES**

### **A DIRECTORS**

#### **A.1 The Board**

##### **Main Principle**

**Every company should be headed by an effective board, which is collectively responsible for the success of the company.**

##### **Supporting Principles**

The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.

All directors must take decisions objectively in the interests of the company.

As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy. Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, executive directors, and in succession planning.

##### **Code Provisions**

A.1.1 The board should meet sufficiently regularly to discharge its duties effectively. There should be a formal schedule of matters specifically reserved for its decision. The annual report should include a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management.

A.1.2 The annual report should identify the chairman, the deputy chairman (where there is one), the chief executive, the senior independent director and the chairmen and members of the nomination, audit and remuneration committees. It should also set out the number of meetings of the board and those committees and individual attendance by directors.

The role of the 'senior independent director' is discussed in the guidance to Section A.3.3 below

A.1.3 The chairman should hold meetings with the non-executive directors without the executives present. Led by the senior independent director, the non-executive directors should meet without the chairman present at least annually to appraise the chairman's performance (as described in A.6.1) and on such other occasions as are deemed appropriate.

The role of the 'senior independent director' is discussed in the guidance to Section A.3.3 below

A.1.4 Where directors have concerns which cannot be resolved about the running of the company or a proposed action, they should ensure that their concerns are recorded in the board minutes. On resignation, a non-executive director should provide a written statement to the chairman, for circulation to the board, if they have any such concerns.

A.1.5 The company should arrange appropriate insurance cover in respect of legal action against its directors.

## **A.2 Chairman and chief executive**

### **Main Principle**

**There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision.**

### **Supporting Principle**

The chairman is responsible for leadership of the board, ensuring its effectiveness on all aspects of its role and setting its agenda. The chairman is also responsible for ensuring that the directors receive accurate, timely and clear information. The chairman should ensure effective communication with shareholders. The chairman

should also facilitate the effective contribution of non-executive directors in particular and ensure constructive relations between executive and non-executive directors.

## Code Provisions

A.2.1 The roles of chairman and chief executive should not be exercised by the same individual. The division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board.

A.2.2<sup>5</sup> The chairman should on appointment meet the independence criteria set out in A.3.1 below. A chief executive should not go on to be chairman of the same company. If exceptionally a board decides that a chief executive should become chairman, the board should consult major shareholders in advance and should set out its reasons to shareholders at the time of the appointment and in the next annual report.

The BSA Model Rules for Building Societies provide for the chairman of a building society to be elected by the society's board for a twelve-month period. On completion of the initial twelve-month term, the chairman may then be re-elected for a further twelve-month term and this process may be repeated in subsequent years. In listed companies, the chairman is appointed for longer – Higgs recommended that a chairman of a listed company should be appointed for a period of not less than three years. In view of this difference in practice between building societies and listed companies, it is suggested that in applying the Combined Code to building societies, the initial election by the board of the chairman of the society is analogous to the 'appointment' of a chairman of a listed company, and building societies should apply the first sentence of Section A.2.2 with this in mind.

The FSA discourages societies from appointing chief executives or other executive directors to the board as non-executive directors after retirement (see: IPRU(BSOC) 3.4.4). In particular, chief executives or other executive directors should not be appointed as chairman following retirement.

## A.3 Board balance and independence

### Main Principle

**The board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking.**

### Supporting Principles

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<sup>5</sup> Compliance or otherwise with this provision need only be reported for the year in which the appointment is made

The board should not be so large as to be unwieldy. The board should be of sufficient size that the balance of skills and experience is appropriate for the requirements of the business and that changes to the board's composition can be managed without undue disruption.

To ensure that power and information are not concentrated in one or two individuals, there should be a strong presence on the board of both executive and non-executive directors.

The value of ensuring that committee membership is refreshed and that undue reliance is not placed on particular individuals should be taken into account in deciding chairmanship and membership of committee.

No one other than the committee chairman and members is entitled to be present at a meeting of the nomination, audit or remuneration committee, but others may attend at the invitation of the committee.

## **Code provisions**

A.3.1 The board should identify in the annual report each non-executive director it considers to be independent<sup>6</sup>. The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director:

- has been an employee of the company- or group within the last five years;
- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;

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<sup>6</sup> A.2.2 states that the chairman should, on appointment, meet the independence criteria set out in this provision, but thereafter the test of independence is not appropriate in relation to the chairman.

- represents a significant shareholder; or
- has served on the board for more than nine years from the date of their first election.

A.3.2 Except for smaller companies<sup>7</sup>, at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent. A smaller company should have at least two independent non-executive directors.

Individual societies should consider how many of their non-executive directors could be classed as ‘independent’, according to the criteria set out in Section A.3.1.

The BSA estimates that, broadly, the building society equivalent of ‘a smaller company’ is any society which is not among the largest 20 societies, ranked by total assets.

A.3.3 The board should appoint one of the independent non-executive directors to be the senior independent director. The senior independent director should be available to shareholders if they have concerns which contact through the normal channels of chairman, chief executive or finance director has failed to resolve or for which such contact is inappropriate.

Whilst some societies have appointed a senior independent director, others have felt that the concept of a senior non-executive director who is not the chairman is of limited relevance to building societies, given that one of the main roles of the senior independent director is to provide a contact point for institutional shareholders.

Societies which do not appoint a senior independent director may want to consider whether it is necessary to offer members an alternative mechanism for the handling of their concerns (i.e. to the arrangements envisaged in Section A.3.3), which acknowledge that members may not always wish to contact the chairman or an executive director. Such societies may also want to consider an alternative method for the annual appraisal of the performance of the chairman (Section A.6.1. envisages a leading role for the senior independent director in the evaluation of the performance of the chairman.)

## A.4 Appointments to the Board

### Main Principle

<sup>7</sup> A smaller company is one that is below the FTSE 350 throughout the year immediately prior to the reporting year.

**There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.**

### **Supporting Principles**

Appointments to the board should be made on merit and against objective criteria. Care should be taken to ensure that appointees have enough time available to devote to the job. This is particularly important in the case of chairmanships.

The board should satisfy itself that plans are in place for orderly succession for appointments to the board and to senior management, so as to maintain an appropriate balance of skills and experience within the company and on the board.

### **Code Provisions**

A.4.1 There should be a nomination committee which should lead the process for board appointments and make recommendations to the board. A majority of members of the nomination committee should be independent non-executive directors. The chairman or an independent non-executive director should chair the committee, but the chairman should not chair the nomination committee when it is dealing with the appointment of a successor to the chairmanship. The nomination committee should make available<sup>8</sup> its terms of reference, explaining its role and the authority delegated to it by the board.

A.4.2 The nomination committee should evaluate the balance of skills, knowledge and experience on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment.

A.4.3 For the appointment of a chairman, the nomination committee should prepare a job specification, including an assessment of the time commitment expected, recognising the need for availability in the event of crises. A chairman's other significant commitments should be disclosed to the board before appointment and included in the annual report. Changes to such commitments should be reported to the board as they arise, and included in the next annual report. No individual should be appointed to a second chairmanship of a FTSE 100 company<sup>9</sup>

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<sup>8</sup> The requirement to make the information available would be met by making it available on request and including the information on the company's website

<sup>9</sup> Compliance or otherwise with this provision need only be reported for the year in which the appointment is made.

A.4.4 The terms and conditions of appointment of non-executive directors should be made available for inspection<sup>10</sup>. The letter of appointment should set out the expected time commitment. Non-executive directors should undertake that they will have sufficient time to meet what is expected of them. Their other significant commitments should be disclosed to the board before appointment, with a broad indication of the time involved and the board should be informed of subsequent changes.

A.4.5 The board should not agree to a full time executive director taking on more than one non-executive directorship in a FTSE 100 company nor the chairmanship of such a company.

A.4.6 A separate section of the annual report should describe the work of the nomination committee, including the process it has used in relation to board appointments. An explanation should be given if neither an external search consultancy nor open advertising has been used in the appointment of a chairman or a non-executive director.

Section A.4.6 says an explanation should be given if a chairman or non-executive director has been appointed without the use of an external search agency or open advertising. In most cases, the chairman of a building society will be appointed from among the existing non-executive directors, a practice supported by the Financial Services Authority. As such, when appointing a new chairman, in order to determine whether an explanation needs to be given under Section A.4.6, societies should have regard to the process by which the chairman was originally appointed to the Board.

An alternative method of recruitment of non-executive directors for building societies – particularly smaller ones - would be to advertise such vacancies within the society's own membership.

## **A.5 Information and professional development**

### **Main Principle**

**The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.**

### **Supporting Principles**

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<sup>10</sup> The terms and conditions of appointment of non-executive directors should be made available for inspection by any person at the company's registered office during normal business hours and at the AGM (for 15 minutes prior to the meeting and during the meeting).

The chairman is responsible for ensuring that the directors receive accurate, timely and clear information. Management has an obligation to provide such information but directors should seek clarification or amplification where necessary.

The chairman should ensure that the directors continually update their skills and the knowledge and familiarity with the company required to fulfil their role both on the board and on board committees. The company should provide the necessary resources for developing and updating its directors' knowledge and capabilities.

Under the direction of the chairman, the company secretary's responsibilities include ensuring good information flows within the board and its committees and between senior management and non-executive directors, as well as facilitating induction and assisting with professional development as required.

The company secretary should be responsible for advising the board through the chairman on all governance matters.

## **Code Provisions**

A.5.1 The chairman should ensure that new directors receive a full, formal and tailored induction on joining the board. As part of this, the company should offer to major shareholders the opportunity to meet a new non-executive director.

There are several references in the Combined Code to 'the major shareholders', 'principal shareholders' and 'institutional shareholders' (see, for example, Sections A.5.1, B.2, D.1.1, D.1.2 and E). Such concepts do not have equivalents in the memberships of building societies. However, the principles underpinning the relevant provisions of the Combined Code are relevant to societies. Main principle D.1 states that:

'There should be a dialogue with shareholders based on the mutual understanding of objectives. The Board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place'.

Societies may wish to consider how dialogue with both shareholding and borrowing members can best be facilitated. Options pursued by some societies include the setting up of members' panels, road shows for members, surveys of members' opinions, member communications managers, focus groups, members' magazines or newsletters, online forums with members and engagement in local activities.

A.5.2 The board should ensure that directors, especially non-executive directors, have access to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities as directors. Committees should be provided with sufficient resources to undertake their duties.

A.5.3 All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are complied with. Both the appointment and removal of the company secretary should be a matter for the board as a whole.

## **A.6 Performance evaluation**

### **Main Principle**

**The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.**

### **Supporting Principle**

Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for board and committee meetings and any other duties). The chairman should act on the results of the performance evaluation by recognising the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors.

### **Code Provision**

A.6.1 The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted. The non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors.

Where a building society has not appointed a senior independent director (see the guidance to Section A.3.3 above), it should include in its annual report an explanation of any alternative arrangements the board has made for the performance evaluation of the chairman.

## **A.7 Re-election**

## **Main Principle**

**All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance. The board should ensure planned and progressive refreshing of the board.**

## **Code Provisions**

A.7.1 All directors should be subject to election by shareholders at the first annual general meeting after their appointment, and to re-election thereafter at intervals of no more than three years. The names of directors submitted for election or re-election should be accompanied by sufficient biographical details and any other relevant information to enable shareholders to take an informed decision on their election.

A.7.2 Non-executive directors should be appointed for specified terms subject to re-election and to Companies Acts provisions relating to the removal of a director. The board should set out to shareholders in the papers accompanying a resolution to elect a non-executive director why they believe an individual should be elected. The chairman should confirm to shareholders when proposing re-election that, following formal performance evaluation, the individual's performance continues to be effective and to demonstrate commitment to the role. Any term beyond six years (e.g. two three-year terms) for a non-executive director should be subject to particularly rigorous review, and should take into account the need for progressive refreshing of the board. Non-executive directors may serve longer than nine years (e.g. three three-year terms), subject to annual re-election. Serving more than nine years could be relevant to the determination of a non-executive director's independence (as set out in provision A.3.1).

## **B REMUNERATION**

### **B.1 The level and Make-up of Remuneration**

#### **Main Principles**

**Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.**

#### **Supporting Principle**

The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution,

in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance. They should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases.

## **Code Provisions**

### **Remuneration policy**

- B.1.1 The performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of shareholders and to give these directors keen incentives to perform at the highest levels. In designing schemes of performance-related remuneration, the remuneration committee should follow the provisions in Schedule A to this Code.
- B.1.2 Executive share options should not be offered at a discount save as permitted by the relevant provisions of the Listing Rules.
- B.1.3 Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for non-executive directors should not include share options. If, exceptionally, options are granted, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until at least one year after the non-executive director leaves the board. Holding of share options could be relevant to the determination of a non-executive director's independence (as set out in provision A.3.1).

Sections B.1.2 and B.1.3 refer to executive share options. Whilst it is not possible to hold share options in a building society, the references to share options would be relevant to building societies to the extent that share options in 'connected undertakings' (eg subsidiaries) of the society are held by building society directors. However, this is somewhat theoretical in that, at the time of writing ie July 2004, the BSA is not aware that there have ever been any such holdings by building society directors.

- B.1.4 Where a company releases an executive director to serve as a non-executive director elsewhere, the remuneration report<sup>12</sup> should include a statement as to

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<sup>12</sup> As required under Directors' Remuneration Report Regulations

Although the Directors' Remuneration Report Regulations do not apply to building societies, the BSA encourages societies to disclose their directors' remuneration policy on an equivalent basis. (BSA Circular No 6108 of 29 July 2004 refers.)

whether or not the director will retain such earnings and, if so, what the remuneration is.

## **Service Contracts and Compensation**

B.1.5 The remuneration committee should carefully consider what compensation commitments (including pension contributions and all other elements) their directors' terms of appointment would entail in the event of early termination. The aim should be to avoid rewarding poor performance. They should take a robust line on reducing compensation to reflect departing directors' obligations to mitigate loss.

B.1.6 Notice or contract periods should be set at one year or less. If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce to one year or less after the initial period.

## **B.2 Procedure**

### **Main Principle**

**There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.**

### **Supporting Principles**

The remuneration committee should consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive directors. The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration. Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest.

The chairman of the board should ensure that the company maintains contact as required with its principal shareholders about remuneration in the same way as for other matters.

See the guidance under section A.5.1 regarding 'principal shareholders.

## **Code Provisions**

- B.2.1 The board should establish a remuneration committee of at least three, or in the case of smaller companies<sup>13</sup> two, members, who should all be independent non-executive directors. The remuneration committee should make available<sup>14</sup> its terms of reference, explaining its role and the authority delegated to it by the board. Where remuneration consultants are appointed, a statement should be made available<sup>15</sup> of whether they have any other connection with the company.
- B.2.2 The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management. The definition of 'senior management' for this purpose should be determined by the board but should normally include the first layer of management below board level.
- B.2.3 The board itself or, where required by the Articles of Association, the shareholders should determine the remuneration of the non-executive directors within the limits set in the Articles of Association. Where permitted by the Articles, the board may however delegate this responsibility to a committee, which might include the chief executive.

In Section B.2.3 there are references to the 'Articles of Association' governing the remuneration of non-executive directors. Although societies do not have Articles of Association, the Building Societies Act 1986 requires equivalent provisions to these to be included in societies' rules. In fact the Building Societies Act requirements go further, in that they apply to 'directors', ie executive directors, as well as non-executives.

- B.2.4 Shareholders should be invited specifically to approve all new long-term incentive schemes (as defined in the Listing Rules) and significant changes to existing schemes, save in the circumstances permitted by the Listing Rules.

The incentive schemes referred to in Section B.2.4 are share-related. B.2.4 does not cover cash-based incentive schemes; however, societies may wish to consider including details of long-term, cash based incentive schemes in the report on directors' remuneration within their annual report and to include a summary of this with the society's summary financial statement.

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<sup>13</sup> See footnote 7

<sup>14</sup> See footnote 8

<sup>15</sup> See footnote 8

## **C ACCOUNTABILITY AND AUDIT**

### **C.1 Financial Reporting**

#### **Main Principle**

**The board should present a balanced and understandable assessment of the company's position and prospects.**

#### **Supporting Principle**

The board's responsibility to present a balanced and understandable assessment extends to interim and other price-sensitive public reports and reports to regulators as well as to information required to be presented by statutory requirements.

#### **Code Provisions**

C.1.1 The directors should explain in the annual report their responsibility for preparing the accounts and there should be a statement by the auditors about their reporting responsibilities.

C.1.2 The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.

### **C.2 Internal Control<sup>16</sup>**

#### **Main Principle**

**The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.**

#### **Code Provision**

C.2.1 The board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems.

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<sup>16</sup> The Turnbull guidance suggests means of applying this part of the Code.

## C.3 Audit Committee and Auditors<sup>17</sup>

### Main Principle

**The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.**

### Code provisions

C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies<sup>18</sup> two, members, who should all be independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

C.3.2 The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- to monitor the integrity of the financial statements of the company, and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to

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<sup>17</sup> The Smith guidance suggests means of applying this part of the Code

<sup>18</sup> See footnote 7

report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

- C.3.3 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available.<sup>19</sup> A separate section of the annual report should describe the work of the committee in discharging those responsibilities.
- C.3.4 The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.
- C.3.5 The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

The Financial Services Authority, in IPRU(BSOC), strongly encourages societies to have an internal audit function and audit committee.

- C.3.6 The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.
- C.3.7 The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

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<sup>19</sup> See footnote 8

## **D RELATIONS WITH SHAREHOLDERS**

### **D.1 Dialogue with Institutional Shareholders**

#### **Main Principle**

**There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.<sup>20</sup>**

#### **Supporting Principles**

Whilst recognising that most shareholder contact is with the chief executive and finance director, the chairman (and the senior independent director and other directors as appropriate) should maintain sufficient contact with major shareholders to understand their issues and concerns.

The board should keep in touch with shareholder opinion in whatever ways are most practical and efficient.

#### **Code Provisions**

D.1.1 The chairman should ensure that the views of shareholders are communicated to the board as a whole. The chairman should discuss governance and strategy with major shareholders. Non-executive directors should be offered the opportunity to attend meetings with major shareholders and should expect to attend them if requested by major shareholders. The senior independent director should attend sufficient meetings with a range of major shareholders to listen to their views in order to help develop a balanced understanding of the issues and concerns of major shareholders.

In regard to dialogue with the 'major shareholders', see the guidance under Section A.5.1

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<sup>20</sup> Nothing in these principles or provisions should be taken to override the general requirements of law to treat shareholders equally in access to information.

D.1.2 The board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about their company, for example through direct face-to-face contact, analysts' or brokers' briefings and surveys of shareholder opinion.

See the guidance under Section A.5.1

## **D.2 Constructive Use of the AGM**

### **Main Principle**

**The board should use the AGM to communicate with investors and to encourage their participation.**

### **Code Provisions**

D.2.1 The company should count all proxy votes and, except where a poll is called, should indicate the level of proxies lodged on each resolution, and the balance for and against the resolution and the number of abstentions, after it has been dealt with on a show of hands. The company should ensure that votes cast are properly received and recorded.

There is a reference in Section D.2.1 to 'abstentions'. Building societies which do not already do so, may wish to consider offering their shareholding and borrowing members the option to abstain at AGM votes. This would be consistent with the BSA's 'Guidance on the Preparations for and Conduct of General Meetings, Including Annual General Meetings'

D.2.2 The company should propose a separate resolution at the AGM on each substantially separate issue and should in particular propose a resolution at the AGM relating to the report and accounts.

D.2.3 The chairman should arrange for the chairmen of the audit, remuneration and nomination committees to be available to answer questions at the AGM and for all directors to attend.

D.2.4 The company should arrange for the Notice of the AGM and related papers to be sent to shareholders at least 20 working days before the meeting.

The notice period of 20 working days in Section D.2.4 is longer than that in the Building Societies Act, which requires 21 days (i.e. both 'working' and 'non-working' days) notice to be given (paragraph 21(1) of Schedule 2 to the Building Societies Act 1986 refers). However, societies have much less time than PLCs in which to issue their annual report and accounts (within 4 months of their reporting year-end, compared to the 7 months allowed for PLCs). It is, accordingly, questionable whether the longer notice period should apply to societies.

## **E. INSTITUTIONAL SHAREHOLDERS<sup>21</sup>**

### **E.1 Dialogue with companies**

#### **Main Principle**

**Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives.**

#### **Supporting Principles**

Institutional shareholders should apply the principles set out in the Institutional Shareholders' Committee's "The Responsibilities of Institutional Shareholders and Agents - Statement of Principles"<sup>22</sup>, which should be reflected in fund manager contracts.

### **E.2 Evaluation of Governance Disclosures**

#### **Main Principle**

**When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional shareholders should give due weight to all relevant factors drawn to their attention.**

#### **Supporting Principle**

Institutional shareholders should consider carefully explanations given for departure from this Code and make reasoned judgements in each case. They should give an explanation to the company, in writing where appropriate, and be prepared to enter a dialogue if they do not accept the company's position. They should avoid a box-ticking approach to assessing a company's corporate

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<sup>21</sup> Agents such as investment managers, or voting services are frequently appointed by institutional shareholders to act on their behalf and these principles should accordingly be read as applying where appropriate to the agents of institutional shareholders.

<sup>22</sup> Available at website: [www.investmentuk.org.uk/press/2002/20021021-01.pdf](http://www.investmentuk.org.uk/press/2002/20021021-01.pdf)

governance. They should bear in mind in particular the size and complexity of the company and the nature of the risks and challenges it faces.

### **E.3 Shareholder Voting**

#### **Main Principle**

**Institutional shareholders have a responsibility to make considered use of their votes.**

#### **Supporting Principles**

Institutional shareholders should take steps to ensure their voting intentions are being translated into practice.

Institutional shareholders should, on request, make available to their clients information on the proportion of resolutions on which votes were cast and non-discretionary proxies lodged.

Major shareholders should attend AGMs where appropriate and practicable. Companies and registrars should facilitate this.

For guidance on the references in this section to ‘institutional shareholders’ and the ‘major shareholders’, see Section A.5.1 above.

## **Schedule A: Provisions on the design of performance related remuneration**

1. The remuneration committee should consider whether the directors should be eligible for annual bonuses. If so, performance conditions should be relevant, stretching and designed to enhance shareholder value. Upper limits should be set and disclosed. There may be a case for part payment in shares to be held for a significant period.
2. The remuneration committee should consider whether the directors should be eligible for benefits under long-term incentive schemes. Traditional share option schemes should be weighed against other kinds of long-term incentive scheme. In normal circumstances, shares granted or other forms of deferred remuneration should not vest, and options should not be exercisable, in less than three years. Directors should be encouraged to hold their shares for a further period after vesting or exercise, subject to the need to finance any costs of acquisition and associated tax liabilities.
3. Any new long-term incentive schemes which are proposed should be approved by shareholders and should preferably replace any existing schemes or at least form part of a well considered overall plan, incorporating existing schemes. The total rewards potentially available should not be excessive.
4. Payouts or grants under all incentive schemes, including new grants under existing share option schemes, should be subject to challenging performance criteria reflecting the company's objectives. Consideration should be given to criteria which reflect the company's performance relative to a group of comparator companies in some key variables such as total shareholder return.
5. Grants under executive share option and other long-term incentive schemes should normally be phased rather than awarded in one large block.
6. In general, only basic salary should be pensionable.
7. The remuneration committee should consider the pension consequences and associated costs to the company of basic salary increases and any other changes in pensionable remuneration, especially for directors close to retirement.

## **Schedule B: Guidance on liability of non-executive directors: care, skill and diligence**

1. Although non-executive directors and executive directors have as board members the same legal duties and objectives, the time devoted to the company's affairs is likely to be significantly less for a non-executive director than for an executive director and the detailed knowledge and experience of a company's affairs that could reasonably be expected of a non-executive director will generally be less than for an executive director. These matters may be relevant in assessing the knowledge, skill and experience which may reasonably be expected of a non-executive director and therefore the care, skill and diligence that a non-executive director may be expected to exercise.
2. In this context, the following elements of the Code may also be particularly relevant.
  - (i) In order to enable directors to fulfil their duties, the Code states that:
    - The letter of appointment of the director should set out the expected time commitment (Code provision A.4.4); and
    - The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. The chairman is responsible for ensuring that the directors are provided by management with accurate, timely and clear information. (Code principles A.5).
  - (ii) Non-executive directors should themselves:
    - Undertake appropriate induction and regularly update and refresh their skills, knowledge and familiarity with the company (Code principle A.5 and provision A.5.1)
    - Seek appropriate clarification or amplification of information and, where necessary, take and follow appropriate professional advice. (Code principle A.5 and provision A.5.2)
    - Where they have concerns about the running of the company or a proposed action, ensure that these are addressed by the board and, to the extent that they are not resolved, ensure that they are recorded in the board minutes (Code provision A.1.4).
    - Give a statement to the board if they have such unresolved concerns on resignation (Code provision A.1.4)
3. It is up to each non-executive director to reach a view as to what is necessary in particular circumstances to comply with the duty of care, skill and diligence they owe as a director to the company. In considering whether or not a person is in breach of that duty, a court would take into account all relevant circumstances. These may include having regard to the above where relevant to the issue of liability of a non-executive director.

## **Schedule C: Disclosure of corporate governance arrangements**

The Listing Rules require a statement to be included in the annual report relating to compliance with the Code, as described in the preamble.

For ease of reference, the specific requirements in the Code for disclosure are set out below:

The annual report should record:

- a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management (A.1.1);
- the names of the chairman, the deputy chairman (where there is one), the chief executive, the senior independent director and the chairmen and members of the nomination, audit and remuneration committees (A.1.2);
- the number of meetings of the board and those committees and individual attendance by directors (A.1.2);
- the names of the non-executive directors whom the board determines to be independent, with reasons where necessary (A.3.1);
- the other significant commitments of the chairman and any changes to them during the year (A.4.3);
- how performance evaluation of the board, its committees and its directors has been conducted (A.6.1);
- the steps the board has taken to ensure that members of the board, and in particular the non-executive, develop an understanding of the views of major shareholders about their company (D.1.2)

The report should also include:

- a separate section describing the work of the nomination committee, including the process it has used in relation to board appointments and an explanation if neither external search consultancy nor open advertising has been used in the appointment of a chairman or a non-executive director (A.4.6);
- a description of the work of the remuneration committee as required under the Directors' Remuneration Reporting Regulations 2002, and including, where an executive director serves as a non-executive director elsewhere, whether or not the director will retain such earnings and, if so, what the remuneration is (B.1.4);
- an explanation from the directors of their responsibility for preparing the accounts and a statement by the auditors about their reporting responsibilities (C.1.1);
- a statement from the directors that the business is a going concern, with supporting assumptions or qualifications as necessary (C.1.2);
- a report that the board has conducted a review of the effectiveness of the group's system of internal controls (C.2.1);

- a separate section describing the work of the audit committee in discharging its responsibilities (C.3.3);
- where there is no internal audit function, the reasons for the absence of such a function (C.3.5);
- where the board does not accept the. audit committee's recommendation on the appointment, reappointment or removal of an external auditor, a statement from the audit committee explaining the recommendation and the reasons why the board has taken a different position (C.3.6); and
- an explanation of how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded (C.3.7).

**The following information should be made available (which may be met by making it available on request and placing the information available on the company's website):**

- the terms of reference of the nomination, remuneration and audit committees, explaining their role and the authority delegated to them by the board (A.4.1, B.2.1 and C.3.3);
- the terms and conditions of appointment of non-executive directors (A.4.4) (see footnote 10 on page 9); and
- where remuneration consultants are appointed, a statement of whether they have any other connection with the company (B.2.1).

**The board should set out to shareholders in the papers accompanying a resolution to elector re-elect:**

- sufficient biographical details to enable shareholders to take an informed decision on their election or re-election (A.7.1).
- why they believe an individual should be elected to a non-executive role (A.7.2).
- on re-election of a non-executive director, confirmation from the chairman that, following formal performance evaluation, the individual's performance continues to be effective and to demonstrate commitment to the role, including commitment of time for board and committee meetings and any other duties (A.7.2).

**The board should set out to shareholders in the papers recommending appointment or reappointment of an external auditor:**

- if the board does not accept the audit committee's recommendation, a statement from the audit committee explaining the recommendation and from the board setting out reasons why they have taken a different position (C.3.6).



**BUILDING  
SOCIETIES  
ASSOCIATION**

**Appendix 3 to the BSA response to the Myners Review of  
Life Mutuals**

# **LISTENING TO MEMBERS**

## **THE BUILDING SOCIETY SECTOR EXPERIENCE**

**SECOND EDITION**

**SEPTEMBER 2004**

**A PAPER BY  
THE BUILDING SOCIETIES ASSOCIATION**

# **THE BUILDING SOCIETY SECTOR EXPERIENCE OF LISTENING TO MEMBERS**

**September 2004**

## **Introduction**

As mutual organisations, building societies are collectively owned by their members. As such they do not have to pay dividends to shareholders and so can offer better rates of interest on mortgages and savings. The earliest building societies can be traced back to the industrial revolution, when they were set up as small local organisations whose members pooled funds to allow them to purchase land and build houses. The first known building society was formed in 1775 in Birmingham and like most early societies was 'terminating', meaning the business was closed after all of its members had been housed.

This changed when societies started accepting deposits from individuals who had no desire to borrow to buy a home, but simply wished to invest their money. No longer terminating, these formed the basis of the 'permanent' societies we know today.

There are 63 building societies in the UK, with assets of over £230 billion. They employ over 40,000 staff who work across the country in head offices and around 2,100 branches, serving more than 15 million savers and over two and a half million borrowers.

Building societies currently account for 18% of all outstanding residential mortgages. On the savings side, building societies hold about 18% of all personal deposits.

## **The 1990s**

The sector faced its own threat in the guise of so-called carpetbaggers in the 1990s. The demutualisations that occurred then led to a sustained attack on the sector as a whole. With one possible exception, these conversions were all director led. However, the conversions created an expectation among the public that easy money could be made by forcing building societies to abandon their mutual status. This was something of a wake-up call. It became clear that societies had not been engaging with their members as much as they should have, but were now asking those members to vote against candidates who wished to demutualise the institution in return for a short-term windfall.

This caused societies to thoroughly review how they communicated and more importantly involved members in the society, its products, services and its organisation.

The sector is much more stable than it was during the spate of demutualisations in the late 1990s. All 63 members of The Building Societies Association are committed to retaining their mutual status and thanks to the campaigns run during the height of carpetbagger activity, far more people are now aware of the benefits of mutuality. However, societies still face challenges year on year, which are resoundingly defeated. For instance at the 2003 Annual General Meeting (AGM) of the Britannia Building Society, there was a turn out of more than 25% and over 90% of its members voted for the existing pro-mutual board. This represents the engagement in the process of over 338,000 people and was the society's largest turnout in an uncontested election.

However, carpetbaggers are getting more sophisticated in the way they approach the issue of attempting to force a society into demutualising. Some have reinvented themselves as democrats; they say they no longer want to demutualise but rather uphold good corporate governance and make societies more democratically accountable. The evidence does not suggest that this is genuine. For instance, in 2003 a candidate seeking election to a building society board on a good corporate governance ticket also ran the “carpetbagger.com” website.

### **Where the sector is now**

Building societies have spent considerable time, effort and money in recent years striving to increase the level of member participation in the affairs of the society, especially voting, which is a fundamental part of the democratic process. However, this can sometimes be a tall order in terms of just where in people’s priorities voting in a building society’s AGM lies. One society recently undertook a survey which revealed that AGM voting ranked many places lower in members’ priorities than voting for ‘Man of the Match’ on TV football.

This puts in context the remarkable success some societies have achieved in the arena of member communication and participation.

In 2002, a report on corporate social responsibility for The Building Societies Association found that 70% of societies have systems in place to ensure members can share their views. For almost a third of societies this constitutes formal policy and approaches range from feedback cards to newsletters to member forums.

The Mansfield Building Society is one of many societies (others include the Cambridge, Cheshire, Dunfermline and Leek United) which produces a member newsletter. It says “In addition to encouraging members to attend the AGM, or exercise their right to vote by completing a proxy voting form, we also use the letter to tell members about our products, services and new initiatives. Also, we include a ‘community corner’ in which we set out the names of various local charities and community events supported by us”

### **AGM voting**

In 1996 Britannia Building Society only had 19,000 out of a potential 1.2 million members voting at their AGM. By 2003, as noted above, the society had increased member turnout to over 338,000. This was achieved by consistently campaigning throughout the year, giving as much information as possible in the most “member friendly” way they could, including making the voter packs easier to understand, extensive advertising as to the benefits of mutuality and donating 10p per vote cast to local and national charities. Other societies that encourage AGM voting by making a donation to charity for each vote cast include the Leek United and the Derbyshire.

Other novel ways of encouraging members to participate in AGMs include the Ipswich Building Society’s practice of inviting a local celebrity to speak. This has boosted AGM attendance from a handful of members to the 150 who attended this year’s event. Other societies hold informal meetings after their AGMs so that members can question members of the board in a more relaxed atmosphere after the formalities of the AGM are completed. Market Harborough Building Society will be introducing similar arrangements in 2005. The Dunfermline Building Society has been so successful in attracting members to its AGM that it has now reached the stage where it can no longer accommodate the meeting at its head office. For 2005 it is looking for a new venue.

The Britannia Building Society has a dedicated phone line for members who wish to listen to the AGM, as do many other societies. Most societies also provide reply paid envelopes, publish the results of their votes on their internet sites and appoint independent scrutineers.

The Derbyshire is one of several societies that ensure all members can have full access to the information, by making the AGM pack available in large print and Braille, and signing the AGM for members with hearing difficulties.

### **New technology**

New technology has started to play its part too. Nationwide Building Society was the first financial services organisation in the UK to webcast its AGM and has done so for the last four years. Other societies such as the Newcastle Building Society also broadcast their AGM live on the Internet.

In 2002, Nationwide Building Society hosted its first online members forum with Chief Executive, Philip Williamson, answering e-mailed questions online in real time. This was very well received. This was not only a first for Nationwide, but again, also a first for a financial services institution. Yorkshire Building Society held a similar event in 2003, attracting 180 questions from members. It plans to repeat the exercise later this year. This kind of communication allows the society to come into contact with people who may not wish to attend an evening meeting, either because of their lifestyle or because it is not a forum in which they would feel comfortable raising an issue. In short it is immediate, accessible, less intimidating and, for some, more convenient.

Societies are also looking at the introduction of electronic voting for their AGMs, as well as the ability to submit AGM questions online, which again would attract a new audience and make voting more convenient for those who use e-mail and the internet. The necessary changes to the law to allow internet voting were passed by Parliament in 2003.

### **Roadshows and Face-To-Face Communication**

Building societies also use more traditional forms of engagement with members such as roadshow meetings with Chief Executives, member magazines and written questionnaires. The Cheshire, Dunfermline, Nationwide, Norwich & Peterborough, Yorkshire, Portman, Newbury and West Bromwich Building Societies (among others) all hold regular members' meetings. There is an ongoing commitment to such meetings in the sector, for instance since 2001 Yorkshire Building Society has held 26 such meetings, and estimates that around 225,000 of its members have been invited to attend, representing about 12.5% of the society's total membership.

Dunfermline Building Society has continued a series of member evenings begun some five years ago. It aims to visit 25% of branch areas each year, giving members the opportunity to question, face-to-face, the chief executive and sales & marketing director. As a direct result of suggestions made by members at these events, various changes have been made to branch layouts and several new products have been introduced. Many other societies are also thinking of introducing member meetings.

Societies recognise that attending a member forum of a building society may not always be the first choice for an evening out, so they have been creative in the way that they put these sessions together. For instance the Cheshire Building Society combine a members forum with its Chairman and CEO with a free tour of a local

place of interest as diverse as historic houses, Bolton Wanderers Football Club and the Jodrell Bank observatory, with the meeting concluding with a viewing of the Cheshire night sky. Britannia runs a programme with the half dozen football clubs with which it has affinity accounts. This gives senior building society staff the opportunity to talk to members and provides members with the incentive to attend.

Following an evening with the Norwich & Peterborough Building Society, Peter Stowesand, a N&P member, commented: "It gave me an insight into how the society operates and its plans for the future. It was good to put a face to the name of chief executive Matthew Bullock. I came out of the meeting feeling that Norwich & Peterborough really cares."

### **Member Panels**

Some schemes such the Yorkshire Building Society member panel have really taken off. In 2001 they decided to establish a member panel whom they could involve in every aspect of the society. The response was overwhelming and they now have a regular panel of over 5,000 members. Members are contacted either by post or phone a maximum of twelve times a year about issues which affect them. The society is able to tailor its communications with the panel to maximise the usefulness of its communications. So, for example, any young homeowners on the panel will not be asked about equity release in retirement as it is probably not a matter at the front of their minds. The feedback from the Yorkshire is that there is a genuine appetite for engagement among its members; people want to be involved and have jumped at the chance to do so. The challenge is in finding the appropriate way to involve members, and demonstrating that the engagement has some tangible outcome.

West Bromwich Building Society recently announced the setting up of its member panel. The panel will initially be comprised of 1,000 of the society's members and will be consulted on a range of matters relating to the management of the society and the products and services it offers.

The Saffron Walden Herts & Essex Building Society asked its members in a questionnaire if they would be willing to be involved in a members' panel. The panel would meet regularly with representatives of the society board to give immediate feedback on current and proposed activity. More than 500 positive responses were received. Initial meetings have been warmly received by attendees, who have shown a great deal of interest in the concept of the panel. The meetings have already led to a lively discussion on issues affecting the society.

The Hanley Economic Building Society set up a customer forum in 2003. This meets quarterly with the chief executive and non-executive directors to discuss key developments in the society. The forum members can – in an informal setting – raise and debate a range of issues of their own choosing. The forum is comprised of 15 to 20 members who will serve a two-year term and then be replaced by new members. The society hopes the forum will provide a source for candidates for non-executive directors as vacancies arise in the future.

Britannia Building Society has established a members' council. This was chosen at random from their membership base, and is chaired by one of their non-executive directors. The panel meets quarterly, for a whole day and sets its own agenda. For instance, last year the board presented its five-year corporate plan to the panel and received plenty of feedback. This enables the society to be accountable and allows members to be involved.

Susan Harrison, a member of the Britannia members' council, commented on her participation, saying "It's obvious this building society is taking the trouble to listen to customers. If nothing else, the meetings have confirmed my view that Britannia is an organisation I can trust."

In response to a questionnaire given by The Mansfield Building Society to all its new members, 13% expressed an interest in participating in a members' forum. The Mansfield now plans to go ahead and hold the first meeting of its members' forum by early 2005.

The Furness Building Society places posters in its branches encouraging members to tell the society's chief executive, Rob Cairns, what they think about its products and services. The scheme has proved popular with members. The Cheshire Building Society has a similar scheme.

The Cheshire, West Bromwich and Yorkshire are among building societies that conduct regular surveys of member satisfaction, The Cheshire and Yorkshire surveys are monthly. 6,000 members of the Yorkshire Building Society receive a questionnaire each month. Feedback from these has indicated satisfaction levels among members of 90%. Any suggestions for change arising from the questionnaire responses are passed to the relevant part of the society to be actioned.

### **Member-nominated Directors**

In 2001 the Derbyshire Building Society offered its members the opportunity to put themselves or another member forward for appointment as a non-executive director. This was to give members greater opportunity to influence the direction of the society and to promote members' interests at board level. In February 2002 Sophie Snell was appointed as a member nominated director. Since then the Derbyshire's website has offered customers the facility to contact her directly via the telephone or e-mail allowing them to raise queries or concerns. Sophie also makes regular branch visits and chairs the customer service committee, which meets quarterly to discuss her findings and other customer service related issues.

Hinckley and Rugby Building Society seeks recommendations from its members when vacancies for non-executive directors arise. A number of directors elected to the society's board were recommended by members in this way.

### **Community Involvement**

Most building societies in the UK are regional organisations which still have their head offices in those areas where they were established. Even those which have a greater geographical spread engage locally with their members. The regional strength of building societies means that they are not homogenous, and do not have a "one size fits all" attitude, unlike many banks and other large corporates. This in turn means that they can be much more responsive to meeting the needs of their own local communities - being part of the fabric of those communities.

Commitment to the local community extends beyond financial or "in kind" support, to the use of local suppliers and engagement with local councils, development groups and schools.

Community involvement is also a way building societies are developing member engagement. For instance, the Barnsley Building Society runs a charitable donation scheme called "Pride in your Community". A panel of interested members is assembled each year. This panel is exclusively member constituted and does not have

any director from the society sitting on it. All members of the society can then nominate an individual or a group who have assisted in keeping their communities together. The distributing panel then decides which local groups should be awarded with between £250 and £500 from a total pot of £10,000. Therefore it is the members of the society who decide how the money the society is donating on their behalf, should be spent.

The Dunfermline Building Society has a full time community relations manager, who is charged to work with the society's sponsored organisations and branches, with educational establishments and with local organisations and groups, to develop its community involvement.

During 2003, the Coventry Building Society's 'TLC in the Community' programme supported 174 separate initiatives, whilst 369 charities received financial or other support from the society or its staff, with a third of its employees having been involved in or associated with a community activity.

The Derbyshire Building Society has a strong focus on the community within its operating area, focusing on groups that represent urban and rural re-generation, and the creation of social inclusion.

The Cheshire Building Society recently received the 'Big Tick' from Business in the Community in acknowledgement of its support for local charities and other good causes. The Hanley Economic Building Society has a community involvement programme which ranges from patronage of the local chamber of commerce to sponsorship of the city of Hanley's citizen of the year award. In celebration of the Hanley's 150<sup>th</sup> anniversary, it has teamed up with two local childrens' charities to which it is on course to donate £10,000 by the end of this year.

The Progressive Building Society has a community awards scheme, under which its members may nominate, for a financial award, an organisation working for the benefit of the local community.

Yorkshire Building Society is one of many societies which have charitable foundations. Since its inception in 1999, £1.5million has been donated by the Yorkshire's charitable foundation to 2,200 causes. 75% of donations were nominated by members.

The Coventry Building Society Charitable Foundation has, since its launch in 1998, donated more than £300,000 to registered charities operating within the Society's branch territory. Like the Yorkshire, the applications from such charities are assessed by a group of independent trustees.

The Newbury Building Society is working with West Berks Education Business Partnership to bring schools and business together to help young people adapt to adult and working life. Currently it is running a series of 1.5 day workshops where groups of 16 and 17 year olds set up their own business, produce a business and marketing plan and give a presentation to a judging panel to find a winning group from the area.

Coventry Building Society has been supportive of partnership initiatives launched by Coventry City Council aimed at stimulating economic activity in the region and thereby assisting the communities where most of the society's members live and

work. The society's chief executive, Martin Ritchley, chairs one of the partnership companies, CV One Limited. In addition to managing an annual budget in excess of £5 million, the company has been successful in generating additional funding from grants and the private sector. The success of the initiative has been such that it is being emulated both within the United Kingdom and elsewhere in the world.

The Furness Building Society supports school savings schemes and has launched a new affinity scheme aimed at raising awareness of financial issues among school children. The Leek United Building Society operates savings schemes within local schools and other initiatives which promote money management skills.

The West Bromwich Building Society operates in an area with a high percentage of people from ethnic minorities and realised that many members did not have English as their first language. This deterred members from coming into a branch or opening accounts, as communication would be difficult. To address this, the society has positively encouraged members of the local community to apply for jobs in branches, to ensure that these other languages were represented. This has helped potential members to feel more comfortable about coming into the branch, thus providing an improved service for the local community and for potentially excluded customers.

In 2003 the Universal Building Society won an award for its artist in residence scheme, under which a local artist worked with local schools, helping them with arts projects and developing the society's links with communities where it has branch offices. This year it plans an ambitious project working with Seven Stories, the national charity for children's literature in which they will be sponsoring an outreach programme to develop children's interest in books and reading.

The staff of the Cambridge Building Society are encouraged to support their local community networks. In 2003 the society's staff donated over 2,100 hours of their own time to help worthwhile causes. The society is introducing a scheme under which it will match the hours donated by staff with cash donations to local charities.

### **Corporate Governance**

Another area where societies have extended engagement is in the boardroom. Corporate governance is becoming more and more important, especially in the post Enron world and societies are addressing the issue of how to involve members at board level. Grass roots representation is important, as it means that societies not only have members' input at the top level, but it is also a signal to all members that their interests are represented. Societies such as the Derbyshire, the Yorkshire, the Nationwide, the Cheshire, Cambridge, Leek United and the Norwich & Peterborough (and many others) have all advertised for non-executive board members to dispel any illusions that appointments are made at the 19<sup>th</sup> hole. Similarly, the Market Harborough Building Society will, as part of next year's AGM mailing, be inviting members to register their interest in becoming a non-executive director.

The Norwich & Peterborough Building Society advertised in East Anglia for two non-executive board members, specifically looking for people with local knowledge in order to become more closely involved in their communities. As a result two local people were appointed and members now have a dedicated phone line if they feel there are any enquiries their two local non-executive directors can help with. Accessibility and appropriate representation for local communities to have their voice heard is vital to the engagement process.

## **Disclosure of Directors' Remuneration**

Major steps are being taken by building societies to improve transparency in respect of directors' remuneration. In 2002 38 societies, in all covering more than 95% of the total membership of all societies, put details of their remuneration policies in their summary financial statement, rather than in only their much less widely read annual reports. This year 18 societies have voluntarily asked their membership to participate in an advisory vote on directors' remuneration policy at their AGM, accounting for over 90% of all building society members. Several more societies are expected to hold such votes next year. Neither of these initiatives were required by legislation.

## **Measurement**

Communication of course is two way – not just pushing messages out, but also listening to what you are being told and acting on this. In other words it is about engagement.

For instance in 2003 the Nationwide Building Society had over 150,000 items of feedback direct from members which led to over 200 service improvements. Identifying issues has led to an 18.7% reduction in complaints. Member feedback has also played its part in the launch of new products and the charitable donation strategy implemented by the Saffron Walden Herts & Essex Building Society.

At the Britannia Building Society member's panel, issues such as improving service at the call centre, keeping members better informed of interest rates changes and changing the opening hours of some branches to better meet local needs have all been raised. Action has been taken as a result of the feedback, which is then communicated back to members.

Market research also plays its part in feedback and improvement. For instance in 2003, Nationwide Building Society conducted 74,000 hours (surveys, group discussions, and individual interviews) with 207,000 people. In addition, over 1,500 people have participated in Nationwide's Usability Centre, which encourages people to think aloud whilst being observed engaging in a variety of tasks from completing forms to using the internet site, to make things easier for members.

The Dunfermline Building Society holds member evenings around Scotland and has recently introduced member information afternoons; the Dunfermline's executive team regularly telephone randomly-chosen members and establish in a fairly short conversation, how the member feels about various aspects of the society; The Dunfermline also commissions mystery shopper exercises, carried out by leading market research companies, by personal visits to branches and through telephone calls to Dunfermline Direct.

## **The Building Societies Association**

As the trade body representing all building societies in the UK, the BSA is playing an active role in encouraging greater member participation and spreading examples of best practice.

Communication with members cannot be sectioned off into neat categories. People read newsletters, talk to branch staff and also receive communication direct from their society. Therefore the Association currently runs a PR Forum, an Internal Communications Forum (for communication to staff) and a Member Communication Forum. These allow practitioners from across the sector to come together and

network, discuss current issues – practicalities and difficulties - and share best practice, thus facilitating greater member engagement in the sector.

The Association encourages building societies to adopt standards of best practice in corporate governance and has developed guidance on the Combined Code on Corporate Governance to help societies to apply similar standards to those which apply to listed companies. Also, the BSA encourages societies to conduct advisory votes of their members on directors' remuneration, as well as providing details of such remuneration in their summary financial statements. In addition, the BSA commissioned the first pan-sector research, report and conference on corporate social responsibility activity undertaken by building societies.

### **Conclusion**

The building society sector has realised that it is not enough for societies to go out and ask for members to support them against carpetbaggers once a year. They are now proactively engaged in communicating to members why mutuality delivers more benefits than plcs, but also listen and are responsive to the feedback they receive from members. There is little evidence that such time and effort is being put into the area of customer communication by the banking sector. This can be attributed to the different organisational structures. Building societies recognise that mutuality means more than just their structure, but informs the relationship they have with their members. Participation and engagement is key to connecting with those members and the evidence from the sector shows that members are keen to reciprocate this contact.