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## Mutual Life Offices Review

Submission by the Mutual Members Campaign.

### Overview

The Mutual Members Campaign was started in 2000 with the aim of using Members' Resolutions to draw public attention to the lack of accountability in the building society sector. Mutual Members' aims and objectives were published in Financial Advisor magazine in January 2001<sup>[1]</sup>. To date Mutual Members has put 22 resolutions to Nationwide and Portman building societies and all have been rejected.

All the resolutions have dealt with internal governance issues and have not sought to interfere in the running of the business or to propose demutualisation. The Mutual Members Campaign has never supported demutualisation although is sometimes portrayed in the press as if it does.

Internal governance is properly a matter for members to discuss and approve in general meeting. Nevertheless boards have been able to purchase legal advice which maintains that members have either encroached on the board's powers of management or that the resolutions have no legal effect.

Stuart Bell the Research Director of Pensions and Investment Research Consultants Ltd (PIRC) stated: "It is simply unacceptable that a company can decide apparently arbitrarily what issues it is willing to have discussed at its AGM"<sup>[2]</sup>. In this case he was talking about BP Amoco's rejection of a shareholder resolution but the same argument applies equally to mutuals.

Building societies are regulated by the Building Societies Act 1986 and its amendments. Mutual Life Assurance companies on the other hand are each regulated by their own act of Parliament and vary widely in their provisions for member participation.

Of great concern to Mutual Members is the fact that the provisions in the Building Societies Act are being adopted by mutual assurers as an example of good practice. Recently Standard Life amended its rules, and although an improvement on what went before, they have adopted the same unworkable framework for member participation as is used by building societies.

The Mutual Members Campaign has given a very public demonstration that the tools laid down in the legislation for members to exercise their rights are unworkable. Members theoretically have the right to put resolutions to the AGM to be voted on. However the arbiter of what constitutes a valid resolution is the society itself. Society managements dislike members' resolutions and view them as an affront to their rights to manage the society. Therefore whatever the subject matter of the resolution a society will always be able to obtain a legal opinion in favour of rejection.

Members only recourse is to take the society to the High Court. Since this is not a practical proposition, members are left without a legal remedy.

At the heart of the problem is a clause in the legislation which allows societies to reject any resolution which is being put for frivolous or vexatious purposes. In the complex area of business law it is not too difficult for lawyers in the pay of the society to argue that any resolution, which a member puts, is either one or the other.

We believe that if members' resolutions are without merit then they should be defeated at the ballot box and not by managements moving heaven and earth to prevent their inclusion on the ballot paper.

In the case of building societies the directors are given additional powers to ignore the results of member ballots if they feel that the proposal will be injurious to the society. Under these circumstances it is difficult to see why managements are so frightened of members exercising their rights. It is also difficult to see how members could ever be in a position to contribute to the running of the society which they own.

It is worth noting that most countries have not adopted the frivolous or vexatious rule into company law because it puts too much power into the hands of the directors. Those countries that have done so provide safeguards against its misuse by having the regulator arbitrate any disputes. In Ireland the Central Bank is the arbiter of any disputes over the validity of members' resolutions. Similarly in the United States the Securities and Exchange Commission arbitrate disputes over members' resolutions.

The UK is unique in allowing paid managers to frustrate the wishes of the owners of a business. The result is an almost total absence of stakeholder participation in contrast to the United States where there is a healthy culture of participation.

In addition to proposing resolutions members may also nominate candidates to stand for election to the board. However boards use a variety of devices to ensure that no independent candidate however well qualified stands a chance of being elected. Colour coding and arrows on the voting form are commonly used to draw members attention toward the board's choice of candidates<sup>[3]</sup>. Imagine the outcry if such a form was used for parliamentary elections<sup>[4]</sup>. Voting forms used to have a 'tick box' for members to authorise their proxy (usually the Chairman) to cast any unused votes as they saw fit. Now a tick box is required to prevent the Chairman from casting any unused votes. This small box is usually located in the small print on the reverse of the form. These devices have now been supplemented with a 'quick vote' scheme linked to a small charitable donation<sup>[5]</sup>.

Mutual Members is in favour of charitable donations but they should not be linked to proxy solicitation in this way.

Another concern of Mutual Members is the protection of members' rights. Consumers of financial products from a mutual institution have two relationships with that institution. They are both customers and members. These relationships are inextricably linked and are often used as a marketing device. As customers they are protected by the Financial Ombudsman Service (FOS). However in their relationship as members no such protection exists. The legislation states that membership disputes have to be settled in the High Court. As stated previously this option is not economically viable for members.

In most cases consumers of financial products from mutuals have a contract that only exists 'at the will of the directors'. Written into all societies rules are clauses that allow the contract to be terminated at any time and no reason has to be given. One would normally expect the rules of Unfair Terms in Consumer Contracts (UTCC) to apply but mutuals are able to side step these rules by inserting unfair terms into their articles of association rather than the rules governing the specific product. (According to the Office of Fair Trading<sup>[6]</sup> the articles of association are exempt from UTCC rules).

Mutual Members would like to see a complete overhaul of the legislation covering mutuals. Successive governments have tried to improve building society accountability but in all cases have failed to do so.

The 1986 Building Societies Act, which arose following the failure of members to put resolutions to the Nationwide Building Society in 1982, has not achieved its objective of making directors more accountable to members.

A key tenet of the 1997 amendment was supposed to improve accountability by allowing members to call Special General Meetings but when a member tried to do so he was advised by the Cheltenham and Gloucester Building Society that he would have to bear the entire cost of the meeting despite the legislation only requiring a £25 per-member deposit.

Statutory instruments were introduced in 1999 supposedly as a temporary measure against carpetbaggers. These measures have been shown to be unnecessary with all attempts to put conversion resolutions thwarted by the management of societies yet the statutory instruments remain in force. The requirement to obtain 500 signatures to support a members' resolution takes no account of the practical difficulties in doing so. Consequently the Mutual Members Campaign which aimed to put resolutions to all of the top twenty societies has only been able to put resolutions to the largest building society, the Nationwide, and one other. In the case of Mutual Life Assurance companies there is not even a branch network for members to stand outside to canvass support.

We suggest that the FOS be made responsible for membership disputes in addition to their current role arbitrating customer disputes. (The FOS or the FSA should also arbitrate the validity of members' resolutions to prevent abuse by the directors. The system in use in the USA provides a good model.)

The criteria for prudential management of mutual societies should be extended to cover conduct of elections. The Irish Building Societies act 1989 specifies that all candidates are to be listed alphabetically and with equal prominence<sup>[7]</sup>. We agree entirely. A level playing field should be established for candidates for the board and the practice of offering members inducements to vote by charitable donation should be outlawed.

## RESPONSES TO THE QUESTIONS:

### Corporate governance guidance

**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?**

We see nothing wrong with the Code itself and think that it has relevance to the mutual sector. The “comply or explain” principle is not well implemented in our experience. Mutuals are keen to trumpet where they comply with the Code but fudge or neglect to inform members where they are deficient. A particular example we could mention is the length of tenure of some non-executive directors. In the building society sector some non-executives effectively have a job for life in spite of the Code’s recommendations, and only seem to retire if ill health prevents their continuance.

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

Since members are unable to exert any pressure whatsoever we see a role for the FSA to include vetting a particular mutual’s ‘statement of compliance’ in their prudential supervision. Where the Code does not have relevance to the mutual form companies could state which parts of the code they have chosen to ignore.

### Policyholder voice

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

Engagement with policyholders seems to only occur on two levels. Members can write to the society or ask questions at the AGM. This is totally inadequate.

Building societies have a lead in this area engaging members in several other ways. Many societies hold ‘roadshow’ type events for members. Some have member panels or other types of focus groups. One society, the Norwich and Peterborough, even has two members of the board specifically chosen to represent the interests of ordinary members.

These efforts although welcome cannot disguise the fact that the formal tools which exist to allow members to express their opinion at company meetings do not work.

In considering members rights to propose resolutions to be voted upon at the AGM we see that mutual Life Assurance companies are each regulated by their own act of Parliament and vary widely in their provisions for member participation. For example Scottish Life before it demutualised would only accept a members’ resolution if 10% of eligible members supported it. This would have required the collection of a figure in excess of 65,000 valid resolution forms, a totally impractical task. At the other end of the scale Standard Life used to require 50 valid signatures although they have now increased this to 1000 to ‘improve’ accountability. We see a need for a consistent and achievable level of support to be set for all mutual assurers. Our view is that 50 signatures is the optimum level of support to discourage frivolous motions but make the proposal of serious motions an achievable objective.

The internet was expected to make things easier for members to organise gathering of the necessary signatures. Our experience is that the internet is no help at all. Unlike proprietary companies, lists of members are secret. Unless members stumble across campaigning websites by accident they will never know what is being proposed.

It is of great concern to Mutual Members that the same unworkable provisions in the Building Societies Act are being adopted by mutual assurers as an example of good practice.

The Building Societies Act describes the machinery for member involvement at society meetings and the machinery is similar to that described in the Companies Act 1985. Although members are in an inherently weaker position than shareholders in a proprietary company, the Act ignores this and every amount, length of time, or percentage is to the detriment of members compared to shareholders in similar circumstances.

In proprietary companies these formal tools are seldom used. Public disagreements could be detrimental to the share price so major shareholders prefer to negotiate directly with boards behind closed doors. This is not an option with mutuals as there is no concentration of ownership so it is important that the formal tools do actually work.

If a member stands as a director candidate, not only is he only allowed half the number of words in his election address, but he has to submit his address before the end of the society's financial year. This puts the candidate in an impossibly weak position since the society will not have even published their annual results at that time.

Building society directors have a duty to put members' resolutions to society meetings however in our experience they do all in their power to prevent them being put.

**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?**

We see no evidence that mutual life offices are more risk averse than their proprietary counterparts. In fact the opposite may well be true. Standard Life's current weakness has to a large extent been caused by management's reluctance to switch from equities into bonds during the recent economic downturn.

Although policyholders are the source of risk capital for the enterprise they do have a measure of control over how much risk they are willing to accept in the choice of which products they invest in. This is not enough though. Policyholders should also be able to exercise their ownership rights at company meetings but are currently unable to do so.

## Regulation

**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 inquiry 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?**

Supervision by the FSA has nothing whatsoever to do with corporate governance. The FSA operates the regulatory regime through the system of prudential supervision. The FSA will only act within the confines of the criteria for prudential supervision and puts the narrowest interpretation possible. Whether the instruments available to the FSA are effective or not we cannot say since they seem totally unprepared to use what powers they do have in defence of members' rights.

The Mutual Members Campaign has brought many matters to the attention of the FSA and its predecessor the Building Societies Commission over the years but they have always declined to act. Even when presented with clear evidence of statutory breaches they refuse to exercise their powers.

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

Given the impossibly weak position that members are in we think that if the lot of members cannot be improved then the FSA should have a role in policing adherence to corporate governance principles. This will have to be put into the criteria though. The FSA will not take it upon itself to monitor corporate governance, they will have to be given a legal responsibility.

## The potential advantages of financial mutuals

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

The pressure to demutualise comes exclusively from the boards of mutual assurers. In the past members have tried to propose demutualisation. Only one member has ever succeeded, Fred Woolard. His proposal to Standard Life failed to win support from members and it is doubtful whether any similar proposal would be accepted today, now that lawyers have been able to manufacture arguments for rejection of any proposal members might put.

In the building society sector it is a similar story. Bradford and Bingley is the only society to ever demutualise as a result of a member proposal, although most independent commentators think that B&B could have rejected the proposal if they had wanted to. Indeed, once members had voted for demutualisation the board proudly boasted that it would be the fastest conversion ever. All other demutualisations have been at the board's instigation from day one.

The reason that European mutuals have not followed the rush to demutualise is that the legislative framework demands that the proceeds of any conversion have to be kept within the mutual sector. Although the directors may stand to benefit from demutualisation, policyholders can not benefit financially from such a move. Under these circumstances the directors have been reluctant to put the issue to a vote.

The main competitive advantage claimed for mutuals is that since they do not have to pay out dividends to shareholders they can provide better value products to members. Mutuals also claim to treat their customers better than proprietary companies. Both statements are true up to a point certainly as far as building societies are concerned.

We see mutuality as a fully viable corporate form ideally suited to long term financial products.

## **Practice in other countries**

**Q16. Are you aware of effective governance regimes for life (or other) mutuals in other countries? Is this the 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 it would be desirable and practical to adopt in the UK?**

One of the worst aspects of the UK legislation relating to member proposals is that if the proposal by some miracle makes it onto the ballot paper and is defeated, the society then enjoys three years protection from any similar resolution being put. Given that most resolutions would have to be special resolutions, then the resolution would have to pass a 75% threshold to be successful.

New ideas take time to develop and be accepted especially if they originate from members. The current system in the UK takes no account of this where members are concerned but allows boards to propose the same resolutions year after year until members do pass them.

The most successful economy on the planet, the USA, operates a different system. Members' proposals only need to gain 3% of the vote at their first attempt, 6% at the next attempt, and 10% thereafter. Only if these percentages are not met do the boards enjoy the three year protection which UK companies currently have.

This system seems eminently sensible and results in a healthy culture of discussion between US companies and their members.

In addition US companies are obliged to accept members' proposals with the Securities and Exchange Commission being the arbiter of any proposal's validity. This again seems sensible given that it is all too easy for the boards of mutuals to purchase legal advice in favour of rejection of any proposal that members might put.

## **Summary of Mutual Members' proposals:**

- Better adherence to the “comply or explain” principle.
- The powers of the FOS should be extended to cover disputes involving membership issues. The cost of arbitration or High Court proceedings leaves members without a remedy.
- Mutuals should not be able to terminate contracts with members ‘at the will of the directors’ and avoid liability under the Unfair Terms in Consumer Contracts legislation.
- As there is no concentration of ownership in mutuals it is important that the formal tools for member participation do actually work.
- The UK should adopt the American model for member proposals both in terms of percentages of support and arbitration of a proposal’s validity.
- Member proposals should require a consistent and achievable level of support to be set for all mutual assurers (and building societies). Amounts, lengths of time, or percentages should be the same as for listed companies and not to the detriment of members.
- Mutuals should not be allowed to validate members’ resolutions. If they wish to reject members’ proposals they should seek leave do so from an independent body like the FSA.
- Mutuals conduct during elections should be scrutinised by the FSA. A ‘level playing field’ should be established for elections. Boards should not be allowed to influence their members’ voting patterns with artistically contrived forms and ‘quick vote’ schemes. All candidates should be listed in alphabetical order. Charitable donations as inducements to vote should also be banned.

#### References:

- [1] FT Financial Advisor magazine, 25<sup>th</sup> January 2001 (Appendix 1.pdf).
- [2] [http://www.trilliuminvest.com/pages/news/news\\_detail.asp?ArticleID=45&Statu=Archive](http://www.trilliuminvest.com/pages/news/news_detail.asp?ArticleID=45&Statu=Archive)
- [3] Portman Building Society voting form 2002 (Appendix 2.jpg).
- [4] Prime Minister voting form (Appendix 3.jpg).
- [5] Britannia Building Society voting form 2004 (Appendix 4.jpg and Appendix5.jpg)
- [6] Letter from the office of Fair Trading. 16/08/2001 (Appendix 6.jpg)
- [7] Irish Building Societies Act 1989 – Part V 50(13)  
<http://www.irishstatutebook.ie/ZZA17Y1989S50.html>

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