

# **MYNERS' REVIEW OF THE GOVERNANCE OF LIFE MUTUALS**

## **RESPONSE BY NATIONWIDE BUILDING SOCIETY**

Nationwide Building Society is a financial mutual constituted (with Memorandum and Rules as required) under the Building Societies Act 1986 and authorised by the Financial Services Authority for the purposes of regulated activities under the Financial Services and Markets Act 2000. The Society had its origins in the middle of the 19<sup>th</sup> century and through organic growth and a history of mergers and transfers of engagements with other building societies is now the largest remaining building society following the wave of demutualization by building societies during the 1990's.

The Society's total assets are in excess of £100bn and it has over 10m members (more than 6m of whom are entitled to vote), as well as non-member customers, all of whom are serviced by the Society and its major operating subsidiaries including its wholly owned proprietary life company. The Society has over 800 branches, growing online and direct business operations and employs c.15,000 employees.

For a number of years the Society has sought to adopt best corporate governance practice as now reflected in the Combined Code on Corporate Governance as if it were a proprietary company. Perhaps uniquely amongst major corporate bodies, whether proprietary or mutual, the Society has faced regular annual challenge by its membership, characterised by members' nomination of candidates to contest board elections almost every year during the last quarter century (some of such candidates were in fact elected) and the submission of members' resolutions to the Annual General Meeting on several occasions during that period.

This response addresses the questions posed by the review in the context of general governance principles for all financial mutuals, without specific consideration of the position of mutual life offices (on which the Society is not best able to comment). The response reproduces the questions in the Consultation Document published by HM Treasury in July 2004 and gives the Society's views on the points raised.

**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?**

A We consider that the current guidance on corporate governance, particularly the Combined Code, is capable of providing an appropriate framework for all financial mutuals, with minimal adaptation necessary to reflect their mutual status. We do not consider that a new Code specifically designed for financial mutuals is necessary or appropriate. In the same way that a proprietary mutual is required to "comply or explain", it is apposite that a financial mutual can (if necessary) explain why it cannot, or chooses not to, follow the Code.

The principle of dialogue between a company and its shareholders embodied in the Code is equally applicable to a financial mutual and its members (whether depositors, borrowers or policyholders etc). Whilst the nature of the dialogue will be somewhat different according to the ownership structure, there should be no presumption that the nature of the dialogue between the proprietary company and its shareholders is inherently superior to the nature of the dialogue between a financial mutual and its members. A shareholder in a proprietary company invests risk capital with a view to profit derived from products and services provided to the company's customers; a member of a financial mutual gives his custom with a view to benefiting from the capital endowed within the business. Accordingly, the nature of the dialogue is simply likely to reflect the interest of the stakeholder.

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

A We consider that the best way of securing financial mutuals' compliance with corporate governance best practice i.e. the Combined Code is through the regulatory system that applies to financial services providers. The FSA's principles and its ability to make rules and provide guidance should be quite sufficient to enable it to ensure the application of appropriate corporate governance standards within 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?**

A We do not consider that the ownership structure of a financial mutual should affect the composition or structure of its board. However the composition of a financial mutual's board needs to reflect the scale and nature of its business, and this is again a matter for consideration within the context of regulatory supervision by the FSA. Such consideration applies equally to a proprietary company and to a mutual within the financial services sector.

**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?**

A We are not in a position to comment specifically on the quality and relevance of information and advice used by the non-executive directors of life mutuals although we have had experience with non-executives on the board of our life assurance subsidiary. Generally we believe there is no distinction to be drawn in this context between a proprietary company and a financial mutual; the non-executive directors must have access to, and make use of, appropriate information and advice sufficient to enable them to fulfil the requirements of a non-executive director as described in the Code.

**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?**

**And**

**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?**

A A non-executive director in a complex or technical business should not necessarily be expected to have expertise in all, or possibly any, of the complexities or technicalities of the business. Naturally, some expertise might help, but a board should not be reliant on non-executive directors' expertise in order to ensure effective challenge to executive management. It is more important that non-executive directors are independent, intelligent, commercially experienced and aware and possess sufficient strength of character to ensure that they receive appropriate induction, training and information (including in relation to specific queries raised), and have access to independent external expert advice if required.

As directors, executives and non-executives should have the same legal duties to the company; however, the executive responsibilities assumed by executive directors are likely to mean that their duties and responsibilities are more extensive and onerous.

**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?**

A We are not best able to comment in relation to policyholder participation in UK life mutuals. However, it appears that (unlike building societies) there is no minimum uniform statutory standard. In the case of building societies, the Building Societies Act 1986 (as amended) defines who is a member of a building society and the minimum rights associated with such membership, which must be set out in a society's rules adopted (and amended from time to time) with members' approval. Membership of a building society extends to all investing shareholders and mortgage borrowers and cannot include anyone else (even though a building society may have customers who do not fall into these categories). To the extent that a building society has customers other than its members (including for example depositors, borrowers on personal loans and credit cards, insurance customers etc) a building society is akin to a proprietary company, insofar as there is a tripartite relationship between it, its members and its customers.

The characteristics of a building society are preserved by the statutory definition of its membership and the statutory imposition of certain business nature limits. Whilst all members are customers, not all customers are members. For example, Nationwide has a commercial lending business, although very few of its commercial borrowers are members, and a life insurance subsidiary, although policyholders do not acquire any membership rights in the Society by virtue of their policies. Our commercial lending business, mostly to corporate bodies who are not members, is undertaken to maximise profit which can be used to enhance the value provided to our membership, whilst our life company subsidiary typically provides policies to customers who are already members of the Society without seeking profit maximisation.

We believe that the role played by the members of a financial mutual in the running of the mutual is no different in concept to the role played by the owners of a proprietary company. Each seeks to influence the value of the relationship they have with their company/mutual, although this value may be measured in different ways. We do not believe there is any case for members of a financial mutual to have an organisation or group other than a society's board to safeguard and enhance their investment and/or their relationship with the mutual. In principle, the role of the board is the same for a financial mutual and a proprietary company, although the manifestation of the role may differ on occasions.

**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?**

A Raising new or additional risk capital from current members is generally not possible in the case of a financial mutual, which will typically have built its risk capital over time for the benefit of the current and future generations of members. Given the fact that risk capital cannot be quickly or easily replaced in a financial mutual if lost, it is likely that financial mutuals will be marginally more risk averse than proprietary companies. However, this factor should not be exaggerated and in any event is probably reflected in capital requirements imposed by, or agreed with, the regulator.

Moreover, in terms of consumer risk (faced by depositors, policy holders etc) the risk of insolvency (in a worst case scenario) on the part of the product provider may be no

different as between financial mutuals on the one hand and proprietary companies on the other hand, and no distinction is made in existing consumer risk protection schemes such as the Financial Services Compensation Scheme.

**Q9 Lord Penrose acknowledges that the FSA's work since 1997 "...has sought to anticipate many of the lessons that might be drawn by its 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?**

**And**

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

A We fully agree that it is not surprising that the FSA's work since 1997 has anticipated many of the lessons that might be drawn from the Penrose Inquiry. We believe that the quality of financial regulation and supervision particularly for life companies (whether proprietary or mutual) has improved in recent years. We believe this is largely due to the emphasis placed by the FSA on senior management (and boards) responsibilities, its foundation of rules and guidance based on stated high level principles and its increasing focus of attention in terms of mitigating consumer risk on firms' methodology for treating customers fairly.

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

A We acknowledge that listed companies are subject to the influence of their shareholders, particularly large shareholders and the risk of takeover. However, it is by no means clear that these factors would have prevented the problems that beset Equitable Life overtaking a proprietary company. It is surely worthy of note that Equitable Life was no doubt itself a large institutional shareholder, which might well call into question the value of shareholder scrutiny at the time. The value of regulatory scrutiny at the time might well also be called into question.

A financial mutual can focus almost exclusively on its customers, whereas a proprietary financial services company needs to focus both on customers and on investors. The ability of a financial mutual to adopt a more single minded approach is a benefit denied to proprietary companies which must manage any conflict or tension between consumers and investors. The ability of customers to withdraw their custom, coupled with heightened regulatory standards, provides a highly effective combined influence on a financial mutual, and we do not believe that the absence of institutional investors gives rise to any artificial need for any additional independent monitoring of financial mutuals.

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

**And**

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

A We believe that well managed financial mutuals enjoy certain inherent advantages. By the same token, badly managed mutuals can squander the advantages.

A main difference in strategic business terms between a financial mutual and a proprietary company is the restriction placed on rapid growth (either organically or

through acquisition) by a financial mutual due to its inability to access additional risk capital. Conversely the status of a financial mutual provides some protection against aggressive predatory activity by a proprietary company.

Demutualisation has tended to be driven by a desire or willingness on the part of members to sell their membership rights for windfalls in the form of cash or shares in a proprietary company. Financial mutuals with business strategies based on rapid growth and/or a willingness to be acquired have found the need to demutualise and this has been easy to achieve through the windfall effect. The most obvious implication of demutualisation for firms, members and customers is the trade off between the receipt of a windfall benefit and the loss of potential future pricing (or other membership) benefits.

**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?**

A As discussed in answer to Q7 above, the governance arrangements under statute currently applicable to building societies are more prescriptive and beneficial to members than appears to be the case with life mutuals. We would suggest that consideration be given to more general application within the financial mutual sector of the standards similar to those that are currently applicable within the building society sector specifically. Coupled with a regulatory requirement that all financial mutuals regulated by the FSA should adopt the “comply or explain” approach to the Combined Code (see our response to Q1 above) we believe the consequence would be greater commonality, consistency and consumer understanding across the financial services sector generally (whether mutual or proprietary).

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

A Scale is likely to influence governance issues to some extent, although there are bound to be certain irreducible minimum standards. The Combined Code for proprietary companies recognises that scale is a factor in this context; equally the FSA has regard to scale in its approach to regulation.

**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?**

A We are not able to comment, except to say that we are not aware of any desirable or best practices applied elsewhere in the world that might benefit the governance of financial mutuals in the UK.

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