

**ISSUES IN THE GOVERNANCE OF MUTUALS IN THE
FINANCIAL SECTOR**

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1. INTRODUCTION

The purpose of this background paper to the Myners Enquiry is to briefly set out an overview of the corporate governance issues related to life mutuals. It attempts to highlight analytical issues related to the governance of mutuals in general and the life assurance sector in particular. It is not designed to discuss detailed aspects of specific corporate governance arrangements or to offer anything of a detailed reform programme. However, it goes on to draw from the analysis some general thoughts on what outcomes might be sought. There is no explicit discussion of the merits and drawbacks of mutuality *per se* which the author has considered elsewhere (e.g. Drake and Llewellyn, 2001).

With respect to plcs, corporate governance has been defined as: “the mechanism by which corporate actions, assets, and agents are directed at achieving corporate objectives established by the corporation’s shareholders” (Sternberg, 2004). The author goes on to argue that corporate governance arrangements “are the means by which corporate agents are held accountable to the shareholders for achieving the corporation’s objectives.” Given that firms (mutuals or plc) utilise economic resources in their activity, issues of corporate governance are economically important for three central reasons. Firstly, there is the issue of what objectives companies pursue and, amongst the various stakeholders in a company, in whose interests companies are run. Secondly, monitoring and control, and the market for corporate control, have an impact on the allocation of resources in the economy, and which firms end up managing economic resources. Thirdly, they impact on the efficiency in the use of resources within firms (Sinha, 1996). The issues are about resource *allocation* and resource *efficiency*. Ideally, we would have corporate governance mechanisms that contribute to an efficient allocation of resources and maximum efficiency in their use. For these reasons, issues of corporate governance and the market for control of firms are not trivial, and inefficiencies in either have significant costs for the economy

As noted by Devriese, *et al* (2004), most of the corporate governance debate has focussed on the governance of non-financial companies and listed companies in particular. With notable exceptions, comparatively little attention has been given to the special governance issues in financial firms in general and mutuals in particular. Making a general point with respect to banks, for instance, and from the perspective of Belgium, Devriese *et al* argue “corporate governance of banks differs from that of non-financial firms. In banks, debt holders are dispersed and non-experts, which limits the effectiveness of debt governance arrangements traditional in non-financial

firms". We find that these issues have more general relevance in the financial sector and with mutuals in particular.

There are several specific issues to consider most especially when comparison is made between optimal governance arrangements between mutual and plc firms:

- In whose interest are economic firms organised?
- The nature of agency problems, and the potential moral hazard associated with the split between ownership and control which is common to all forms of economic firm.
- How agency problems and moral hazard are best handled.
- The nature and form of the monitoring mechanisms of firms.
- Who undertakes costly monitoring, and how effective the monitoring and discipline of firms is in practice?
- Is the market for corporate control (the take-over market) of plcs efficient in creating an efficient allocation of resources in the economy and the management of resources used by firms?
- What are the *incentives, abilities and feasibilities* of effective monitoring of mutuals and plcs? This raises issues about the incentive structures for owners to monitor and discipline firms; about their technical capacity to do so (access to information and the ability to use relevant information, etc.), and whether it is feasible in practice for owners to monitor and control.

The report is structured as follows. Part 1 considers some general analytical issues of relevance to corporate governance in the context of what will be termed the *Agency Paradigm*. This is followed in Part 2 by more detailed consideration of financial mutuals. Part 3 makes a set of general recommendations based on the analysis of Parts 1 and 2. The Appendix summarises the main principles of the Combined Code of Corporate Governance.

I. THE ANALYTICAL FRAMEWORK.

2. THE ECONOMIC FIRM

A useful starting point in any analysis of mutuality is that mutuals are economic firms, i.e. organisations which use resources to add value in the creation of goods and services. In this regard, a mutual is one amongst many types of economic firm: sole proprietors, closed companies, partnerships, plcs, cooperatives, state-owned agencies, etc. However, both in this country and elsewhere there has been a sharp fall in the number of (especially large) mutual financial firms in the building society and life assurance sectors (Swiss Re, 1999).

Different types of firm often compete with each other in the same markets. Mutuals are, therefore, one of many forms for organising economic activity. Each type of firm has its own strengths and weaknesses, which is why different organisational forms are able to co-exist and (as in the building society and life assurance sectors) sometimes in direct competition with each other. Although different types of firm perform the same economic role, there are several key differences between them:

- in their ownership structure: who owns the firm (e.g., as between individual and institutional ownership);
- the capital structure of the firm;
- the nature of ownership stakes (e.g. as between, for instance, tradable shares or liquid deposits);
- who takes the residual risk of the firm;
- how principal-agent problems are handled when there is a split between owners and managers;
- to whom managers are accountable and how they are made accountable for their actions;
- how ownership of the firm may change (e.g. mergers, take-overs etc.).

These are issues common to all firms but are handled differently in different types of economic organisation.

More formally, any firm is a set of contracts among the various factors of production, agents or "stakeholders" within the organisation. Clearly, within this paradigm there are many alternative ways in which these sets of contracts can be structured and the mutual form is simply one amongst many possible corporate forms. A key difference between a mutual and a plc firm is that in the mutual the customers are themselves the owners of the firm whereas there is a separation of the two in the case of the plc.

The mutual corporate form has been prevalent, and has a long history, in financial services but much less common in non-financial business areas. Mabbett (2001) notes that "for much of the twentieth century, insurance against risks faced by householders was understood to be an inherently mutual activity". Mutual institutions have often dominated housing finance and life assurance markets, both in the UK and in many other developed economies such as the US. In many ways, mutuality may be particularly suited to the provision of financial services, and especially those relating to longer term contractual relationships such as mortgages and life assurance. This may be due to in part to the possibility that, under some circumstances, financial mutuals are able to address any inherent agency problems more efficiently.

Since external suppliers of capital to plc institutions need to be remunerated (in the form of a required rate of return on equity), the absence of external shareholders might be deemed to be an inherent “efficiency advantage” of financial mutuals in the sense that, other things being equal, they are able to operate without the necessity of servicing and remunerating externally supplied capital.

There are good reasons why different corporate forms may coexist within the same marketplace, and indeed there are clear advantages in such a diversity of corporate form. There is a clear economic rationale for the predominance of certain corporate forms (such as mutuals) in cases where institutions are relatively narrowly focused on providing long-term contractual relationships and financial products such as mortgages and life assurance. There are systemic benefits to the existence of a continuing and thriving mutual sector in the sense that these institutions tend to adopt a lower risk profile, are not subject to the asset substitution agency problem (see below), and should therefore not be subject to the “herd instinct” to the same degree. This suggests that a financial system characterised by a mixed array of corporate structures such as plcs and mutuals will be inherently more stable than one populated by only the former.

A key issue is whether a firm’s behaviour is determined more by ownership structure and corporate governance arrangements as opposed to competitive conditions in the markets for goods and services. In many ways the latter is more powerful than the former, and strong competitive conditions in final markets may at times alleviate some of the problems implicit in less than perfect corporate governance arrangements of whatever type of firm is being considered. This is an important perspective when considering the alleged weaknesses in corporate governance arrangements within the mutual sector as both building societies and mutual life offices operate in highly competitive markets. The discipline of competition in the markets for what firms supply is more powerful than particular corporate governance arrangements. In the hypothetical world of perfect competition in all markets, issues of corporate governance would be of second-order importance (if important at all) in terms of what really matters: the efficiency in the allocation of resources, and the efficiency in the use of resources. However, corporate governance issues are of significance because the ideal model of perfect competition does not exist in practice. Although, for reasons outlined below, corporate governance issues in mutuals are important, a sense of proportion is needed when they are operating in highly competitive markets.

3. ORIGIN OF GOVERNANCE ISSUES: AGENCY ISSUES

Agency problems (potential conflicts of interest between managers and owners of firms) can arise in any organisation in which there is a separation of decision and risk-taking functions (in the case of mutuals between the management and the Members; in the case of plcs between management and shareholders). This particularly arises when important decision agents do not bear a substantial share of the wealth effects of their decisions (Fama and Jensen, 1983). A potential moral hazard arises as managers may be induced to behave in their own interests rather than those of shareholders. While there is a wide variety of different types of economic firm, the common corporate governance issue is how owners (residual claimants) or shareholders ensure that managers protect their interests.

The so-called “agency problem” in firms is generally characterised as a problem emanating from the separation of ownership and control. Potential conflicts of interest (between managers and owners) arise because contracts are necessarily incomplete: it is not feasible to set down in advance a set of complete contracts that specify courses of action for each stake-holder in all conceivable future circumstances. Although there must necessarily be discretion, the discretion of managers can be abused and operate against the interest of owners.

Hart (1995) notes that corporate governance issues arise in particular when: (1) agency problems (conflicts with interest) arise within a firm, and (2) transactions costs are such that the problem cannot be dealt with through explicit contracts. Also in this context, Fama and Jensen (1983) argue that agency problems arise because contracts are not costlessly written and enforced. Agency costs also include the value of any outputs lost due to the fact that the costs of full enforcement of contracts are greater than the benefits. Clearly therefore, agency problems can arise in both plc and mutual financial institutions such as life offices.

With respect to corporate governance arrangements, the central idea is that owners of firms (whether they be shareholders of a company or members of a mutual) delegate to management the job of running the firm and operating it in the owners’ interests. In particular, management are supposed to pursue policies which maximise the benefit of owners. This amounts to maximising shareholder-value in the case of a plc. In turn, the shareholders/owners monitor and control management to prevent them exploiting their advantageous position. The monitoring and control of management is designed to ensure they behave in the interests of the owners rather than pursue their

own interests. The question arises as to whether, in practice, owners can effectively monitor and control management. This is a key issue in corporate governance.

There are three complications with respect to maximising value in the case of mutuals: (1) there is no formal separation between owners and customers, (2) the concept of “ownership” is less clearly defined, and (3) it is less clear what “maximising owner value” is in a mutual and also who precisely who the owners are and what precisely their ownership rights are.

A key element in this debate typically centres on the differences in ownership structure and the often-alleged greater scope for managers of financial mutuals to engage in rent-seeking or expense-preference behaviour. In other words, it is typically asserted that agency costs are potentially more serious in mutuals than in plcs because the owners (investors and borrowers) of the former have less influence on managers than do their equity shareholding counterparts. This is partly because they are larger in number, have smaller ownership stakes, and are more dispersed. This, view can, however, be questioned.

On the other hand, fraud (rather than expense-preference behaviour) can be a more serious problem in any firm. This can be achieved, for instance, through connected-party transactions at less than arms'-length prices that do not reflect the full value of assets being transferred. This is typically easier to undertake in a proprietary company than in a mutual which does not have shares as currency, nor an easy mechanism for management to extract value on a substantial scale.

4. THE AGENCY PARADIGM

Issues of corporate governance need to be considered in the wider context of the nexus of *influence*, *control*, *protection*, and *sanction* with respect to agency problems, and the various mechanisms that are available to achieve them. We have identified that issues of corporate control and the handling of principal-agent and moral hazard problems are of significance. As was established previously, potential agency problems are likely to arise in any large and relatively complex organisation. The key issues are the measures in place to deal with these potential agency problems and the economic significance of any remaining agency costs. In what might be termed the *Agency Paradigm* several mechanisms have emerged to deal with agency problems. These may be summarised as:

- **Exit** (where dissatisfied shareholders in a plc sell their ownership stake which may have an impact on the share price, or where Members of a mutual liquidate their stake by, for instance, withdrawing funds or cancelling contracts).
- **Voice** (where shareholders exert pressure on management to pursue correct policies). See, for instance, Zeckhauser and Pound (1980).
- **Governance arrangements.**
- **Accountability.** The mechanisms through which management is held accountable to owners.
- **Labour market.** The labour market in executives can be a disciplining factor to the extent that managers seek to enhance their personal market value by creating a reputation for success (Fama, 1980).
- The **market in corporate control** where the take-over market can exert pressure on management to be efficient and pursue policies that maximise shareholder-value, (Grossman and Hart, 1998, Jensen, 1988).
- **Capital market pressure** where price signals indicate shareholders' and creditors' views about the worth of the company and the quality of management and business strategy, and also determine the cost of capital and debt. This has been discussed with respect to the debt market and the threat of bankruptcy (Jensen, 1986) and the monitoring by debt holders (Hoshi, et. al., 1990).
- **Regulation** through which, in some areas, the behaviour of management is constrained by prudential and conduct of business regulation and supervision. Holmstrom and Tirole (1993) also consider the monitoring by financial market analysts.
- **Publicity:** the behaviour of management and the business operations of the firm are scrutinised enabling stakeholders to make informed judgements about the firm.
- **Competition** in the market place for the products and services being offered, (Nickell, 1996 and Heinrich, 2000).

Different elements of the paradigm are relevant for different aspects of a firm's business and may operate differently as between plcs and mutuals. Thus, for instance, while capital market pressure may at times be powerful in disciplining plcs, it is considerably weaker (if relevant at all) in the case of mutuals which do not have tradable ownership stakes.

To some extent there is a trade-off between the different components of the *Agency Paradigm* implying that weakness in one area may need to be compensated by stronger elements elsewhere. Thus if some elements are weak or non-existent in the case of mutuals, compensation may be needed through other routes. In particular, and as argued below, the absence of an effective market in corporate control suggests that corporate governance mechanisms need to be stronger with more weight placed on them in mutuals.

5. AGENCY PARADIGM MECHANISMS

The manner in which some of the mechanisms in the paradigm work (or are thought to work) are discussed in this section in so far as they are relevant for corporate governance issues. A particular issue is the exit-voice dichotomy: in the absence of effective voice (i.e. ability to change the behaviour of a firm and its management) an agent has the option of withdrawing business from the firm such as withdrawing deposits. The mechanisms within the *Agency Paradigm* may be characterised as internal or external: the former includes voice, governance arrangements, and accountability mechanisms, and the second includes the market in corporate control, the role of rating agencies, and competition in product markets.

Exit

The theory is simple to state: a dissatisfied member or shareholder has the simple option of withdrawing from the firm. In the case of depositors, for instance, this can be done at low cost. Equally, a shareholder with a tradable ownership stake in a firm has the option of selling the stake in the secondary market. However, in some areas (such as long-term contracts including life assurance or personal pensions) while the option exists in theory, the exit costs (such as penalties, market-adjustment, etc) may be prohibitive to the extent that it effectively removes the exit option as a realistic possibility. Thus the exit mechanism may not be universal dependent upon the transaction costs involved.

Voice

A major determinant of internal v. external monitoring and control is the structure of stakeholders' incentives, ability and feasibility to exercise voice. This in turn is powerfully influenced by the degree of concentration or dispersion in ownership. It must also be borne in mind that monitoring is a costly activity and hence there must be a sufficiently strong incentive (potential reward) for shareholders to incur these costs. When ownership is dispersed (a large number of shareholders with no dominant holdings) incentives are weak, ability to control is low, and feasibility of control is weak. In the first case, no individual small shareholder has an incentive to

monitor because his or her stake is low. The individual bears the full cost of monitoring but reaps few of the benefits. There would also be uneconomic duplication if all small shareholders were to conduct their own monitoring. This creates the standard free-rider problem: all seek to gain the benefit (but not incur the cost) of the monitoring activities of others. Expertise is also likely to be low as small stakeholdings make it uneconomic to acquire the necessary information and expertise to conduct effective monitoring. It is also not feasible to exercise control as, in practice, voice is not heard when the sanction that can be imposed by a small shareholder is weak. The existence of a large number of small shareholders also makes it difficult to organise coalitions.

It is also the case that the perception amongst Members of mutuals that they are in fact owners with ownership rights is probably weak as most regard themselves exclusively as customers.

On the other hand, the problems of voice do not arise so powerfully when ownership is concentrated: incentives are strong; expertise can be gained, and feasibility is high. Thus concentrated ownership can create efficient internal monitoring and control and alleviate potential agency problems and moral hazard. The voice mechanism is potentially powerful when ownership is not excessively diffused. Active institutional shareholding becomes feasible when either ownership is concentrated in a small number of large shareholders who are willing and able to commit resources to monitoring and control, and who have incentives to do so. This can create a powerful discipline and control ethos (Shleifer and Vishny, 1986). Large shareholdings (as in Germany and Japan) may, therefore, mitigate agency problems. Having shareholders represented on the Board of Directors may have the same effect. There is also evidence that, having Non-Executive Directors on the Board (as advocated by the Cadbury Committee) tends to improve company performance (Baysinger and Butler, 1985; Weisbach, 1988). There is evidence that the turnover of Board members in poorly performing companies tends to be greater when there is a high proportion of outside (non-executive) directors (Franks et al., 1995).

Governance

Corporate governance structures relate to: 'institutional arrangements which are designed to control relationships between the various stakeholders in firms, and which affect the actions of different stakeholders' (Gelauff and de Broeder, 1997).

Specific corporate governance arrangements can influence the performance of firms (whether they be mutual or corporate) in several ways. Mayer (1996) identifies five

channels: (1) through the incentives they create, and in particular the extent to which they align interests in the principal-agent relationship between shareholders and managers of firms; (2) through discipline effects (i.e. whether particular corporate governance arrangements facilitate the monitoring and disciplining of managers); (3) via re-structuring of companies through changes in ownership stakes; (4) via finance and investment (e.g. the incentives for, and the role of, debt and equity finance), and (5) the extent of commitment, i.e. whether stake-holders in the firm have an incentive or ability to develop long-term commitments.

The market in Corporate Control

A major difference between mutuals and plcs relates to the market in corporate control or take-over market. With respect to the external mechanisms within the *Agency Paradigm* (e.g., the take-over market) many analysts argue that, while the operation of internal corporate governance mechanisms in public companies is far from perfect, this is at least partly mitigated by an active market in corporate control. In this respect, there may be something of a trade-off between internal and external mechanisms. However, when analysis is made of the way the take-over market works in practice, it is found to be far from the ideal textbook case (see Holmes and Llewellyn, 1997).

A distinction is made between the market for shares and the market in control. The two involve different prices, transactors, and information sets. In practice, the former is very competitive with a large number of transactors and intermediaries (brokers, advisers, market-makers etc.). The market for control, on the other hand, is competitive though there are considerably fewer transactors.

The basic theory behind the market for corporate control is simple enough and is outlined succinctly in Scharfstein (1988). The take-over market disciplines management to be efficient and to maximise shareholder-value. This is because if they do not do so the share price falls and this gives an opportunity for an alternative management team to make a bid for the company because they believe they can manage the resources of the target company more efficiently. Because of this they can afford to pay a higher price for shares than the prevailing market price. In theory, resources in the economy end up being managed and controlled by the most efficient management teams. It is largely the *threat* of take-over that acts as the discipline on management. In addition, actual takeovers can, in some cases, enhance the interests of shareholders because of the benefits that derive from economies of scale, synergies between companies, superior management, or superior business strategies of the

purchasing firm. In effect, the market is for the control of the resources embodied within the company, and if an alternative management group judges it can use those resources more efficiently to enhance shareholder-value, existing shareholders have an incentive to sell to the bidder. This, of course, assumes that maximising shareholder-value is the route towards maximising efficiency in both the allocation of resources and in their use.

We can take this a stage further, in that if the share price is undervalued because of the weak strategies of the incumbent management, rival bids can be made for control of the company's equity. In effect, competition develops among rival teams and, in theory, resources end up in that team which can manage them most efficiently (Ruback, 1988).

In theory, therefore, the existence of an active market in corporate control acts as an incentive on management to behave in a way that enhances shareholder-value. It is the threat of potential take-over that is the offset to the exploitation of moral hazard by managers. If this works effectively the agency costs associated with the divorce of ownership and control are minimised.

It is frequently alleged that a major weakness of the mutual form in building societies and Life Offices is that, as there is no market in ownership, there is no scope for capital market discipline to be exercised. However, heroic assumptions need to be made before we can be confident that the absence of a market in the ownership of mutuals creates a serious problem. In fact, it is only in the Anglo-Saxon world that this argument would be used at all: it is not the norm in many economic systems throughout the world, most notably not in Germany and Japan. The position has been put well in a *Financial Times* leader (February 10th, 1996):

Since many takeovers fail to achieve adequate returns for shareholders and some fail disastrously, it would seem logical to expect the shares of an acquiring company to go to a bigger discount. The fact that they do not reflects not merely the triumph of hope over experience, nor the incantations of merchant bankers and financial PRs, but the stock market's bias for action... In the case of mergers, shareholders of the acquiring company must satisfy themselves that there are real potential gains to be made from the combination, with a probability of success great enough to offset the generally unfavourable outcome of such transactions.

Overall, a sense of proportion is needed when considering the inefficiency consequences of not having an active market in corporate control in the mutual sector. Nevertheless, whatever the outcome of actual takeovers and mergers might be in practice, the threat of such activity is a potentially powerful discipline on

management as they stand to lose control of the firm and the reserves and potential income streams embodied within it.

Regulation

Regulation and official agency supervision has a role in addressing potential agency problems and is a component of the *Agency Paradigm* as described above. As put by Devriese, et. al. (2004):

“the high proportion of debts in the total liabilities (of banks), and the resultant high leverage, facilitate risk-shifting by shareholders. Hence there is a need for a representative of depositors to ‘mimic’ the role taken by debt holders in non-financial firms. Typically, this role will be performed by a regulatory and supervisory authority”

Thus the goal of official agency regulation and supervision to constrain the behaviour of financial firms is to complement other mechanisms designed to limit risk-taking and potentially hazardous behaviour which includes minimising agency costs.

A key issue is the precise role that regulation should have in the overall *Agency Paradigm*. One role is to correct for weaknesses elsewhere in the paradigm. It is clear that the agency problem of asset substitution (see below) is closely related to the issue of financial regulation and this is illustrated in the recent theoretical analysis in this area. Dewatripont and Tirole (1993) and Tirole (1994), for example, highlight the explicit corporate governance role of financial regulation. In the case of plcs there may be an incentive for management, acting in the interests of the shareholders, to take excessive risks at the expense of depositors, particularly when the firm is performing badly. A strategy of gambling for resurrection (double or quits) makes sense to shareholders when the value of existing equity is low. The moral hazard is that there may be incentives to take excessive risks as the value of equity falls. This tendency towards excessive risk taking in plc financial institutions may also be reinforced by the well-known moral hazard problems introduced by either explicit or implicit (‘too big to fail’) deposit insurance.

Competition

Competitive markets are themselves a major disciplining mechanism on management. Baumol *et al* (1989) go further and argue, in the context of the US mutual fund industry) that competition between funds was the main actor restraining administration charges. In practice, competitive pressures rather than corporate structure are likely to dominate the behaviour of financial firms most especially when mutuals and plc firms operate in the same markets in competition with each other (Drake and Llewellyn, 1997). It has also been argued that the co-existence of mutuals

and plcs in the same market place can intensify competitive pressures for the benefit of consumers (Llewellyn, 1997). Field (1996) has also argued that the participation of new mutual associations could “add yet a new cutting edge to competitive forces” in the pensions sector.

However, a market can be very competitive (as measured in normal ways) but competition may nevertheless not be *effective* in the market place. Even though there may be many competitors in a market, competition is effective only if consumers are (i) able to make a rational choice between competitors, and (ii) are able to exercise choice at low transactions costs. Both may be impeded. There are many reasons why, in some financial markets, consumers are unable to make rational choices: lack of relevant information, the complexity of products, the complexity of charges, headline pricing to conceal other characteristics, obfuscatory pricing, the inability to observe quality at the point of purchase, etc. If consumers do not have sufficient information by which to make comparisons and rational choices, competition between suppliers may not be effective in practice even though there may be many independent competitors. Independent research commissioned by Abbey National has revealed that more than half of current account holders were unaware that they could obtain higher interest rates if they switched banks.

Even if consumers are able to make rational choices, the transactions costs of exercising this choice may be high:

- the *bundling* of products and services such that the purchase of one service may be dependent on the purchase of other services;
- there may be considerable inconvenience attached to buying a particular product from the “best” financial firm if, because of bundling, many other services need to be switched;
- switching costs may be high;
- consumer inertia may inhibit switching and the search for the “best” deal;
- redemption penalties may be high in some financial products especially those of a long-term nature, and
- there may be costs in disturbing an existing relationship with a financial firm because of the information transfer gained through a long-term association. It means that there may be considerable inertia in switching business. This was found to be the case, for instance, in the recent UK Competition Commission report on banking services to SMEs.

In effect, information is the major constraint in (i) and transactions costs in (ii). Combined they can have the effect of limiting the effectiveness of competition even in a market place which has many competitors.

The effectiveness of competition may also be determined by the type of good or service being purchased. A distinction is made between: *search*, *experience* and *credence* goods and services. The distinction is relevant for both information and transactions costs issues. In the case of *search* goods, quality and price can be ascertained at low cost prior to purchase or where a credible warranty is attached. *Experience* goods are those whose quality can be ascertained at low cost through use though not prior to purchase. A *credence* goods, on the other hand, is where quality can be ascertained only at some cost after purchase and, in its extreme form (such as some long-term investment products) may never be fully open to objective evaluation. A frequent characteristic of these goods and services is that the value of the purchase is either spread over a long period of time, or emerges only after a considerable lapse of time.

One of the other characteristics of many financial transactions is that they involve *incomplete contracts*, in that their value is determined in large part by the behaviour of the seller/supplier after the point of purchase. Two obvious examples are where an investment manager turns out to be incompetent or even corrupt, or where a financial institution becomes insolvent while having fiduciary commitments to its customers.

All of these considerations may impair the effectiveness of competition even though there are many competitors.

6. IMPEDIMENTS IN THE PARADIGM

A major determinant of internal v. external monitoring and control is the structure of *incentives*, *ability* and *feasibility* which in turn is powerfully influenced by the degree of concentration or dispersion in ownership.

The limitations of voice have already been outlined. The perception that official agencies conduct effective monitoring and intervention (perhaps based on an assumption of superior information) may also weaken the incentives for others to conduct costly monitoring in the belief that they are only duplicating monitoring which is already being undertaken by an official agency. Market participants might

also judge that official supervisors have the advantage of economies of scale and also information advantages that they themselves do not have. If, for any reason, there is a perception that a financial firm will be somehow rescued in the event of distress, or that compensation will be forthcoming in the event of failure, the incentive to incur monitoring costs will be low. The general point is that incentives to monitor (and incur the costs of so doing) rise as the costs of doing so decline, and rise the greater are the losses in the event of a failure. The key, therefore, is to lower the costs and raise the benefits of private monitoring.

This question mark over the motivation of shareholders to actively monitor the decisions of firm managers prompts the property rights literature to emphasise the role of substitute or delegated monitoring. The most obvious example of delegated monitoring is the role of the Board of directors in large organisations, and particularly the role of non-executive directors on those Boards. Indeed, the presence of non-executives on Boards in all plcs is itself indicative of the extremely imperfect monitoring afforded by shareholders.

7. STAKEHOLDER MONITORS & THEIR INCENTIVES

There are many stakeholders in any economic firm, whether it be a company, mutual, partnership, co-operative etc. By stakeholder is meant an agent who has invested in assets of one sort or another that are specific to the relationship with the firm, and are at risk in the enterprise (Blair, 1995). This excludes simple buying and selling activity except where a long-term relationship is involved, most especially if this is of a fiduciary nature. In essence, the return on the relationship-specific investment of a particular stakeholder depends in part on the actions of others in the firm. Stakeholders, as the name implies, have something at stake in the relative success of the financial firm. Those who participate in the process of observing the behaviour of the firm and forming judgements in the light of it have been described in Llewellyn and Mayes (2004) as “stakeholder monitors” (SHMs).

With respect to incentives within the plc firm, there are several general mechanisms designed to encourage management to behave in the interests of the owners:

- Salary incentives that align the interests of shareholders and managers. Examples include compensation packages related to the performance of the share price (Baker et al. 1988 and Kole, 1997).
- Share options and share ownership by executives (Jensen and Meckling, 1976) so that the interests of managers and owners are aligned.
- Executive presentations, discussions and regular contact with institutional shareholders. Mallin (1978) notes that British clearing banks individually

have a close relationship with their institutional investors, and that regular meetings are held during the year on such issues as current and future strategy, quality of management etc.

- An active employment market for senior executives whose salary may be determined by past success and performance in other firms.
- If a bank is a major stakeholder, it can influence management by the availability and terms of credit and the incorporation of covenants in loan contracts.

There are several potential *stakeholder monitors* in life mutuals who perform their roles in different ways:

- **Members** are both the beneficial owners of the business and its customers and therefore have two interests in the policy of the firm.
- **The FSA** has interests in financial stability, consumer protection and prudential regulation of all financial firms.
- **IFAs** who distribute products of life offices to customers have an interest in the quality of the product and viability of the firm even though (notwithstanding FSA monitoring) their judgement might be clouded by commission incentives.
- **Journalists and other commentators** broadcast generic advice and selected information.
- **Rating agencies** provide financial strength rating of larger mutuals and debt rating where relevant to paying customers (life offices, brokers, “sophisticated” customers).
- **Other life mutuals** have an interest in the reputation of the life sector in general, and mutuals in particular, in order to minimise contamination risk through the bad behaviour of others: the negative “halo effect”.
- **Government** has a general policy interest in financial stability, fair and efficient markets and consumer protection and welfare.
- **Debt holders’** interests are predominantly to limit risk-taking in the financial firm.
- **Owners (Members)** are the ultimate risk-takers and have an expectation of a rate of return on invested funds.

Bearing in mind that monitoring is not a costless activity, all SHMs need incentives to perform their different roles:

- **Members** have a direct financial interest in the performance of their product, but may not appreciate the wider strategic dimensions of the business and the impact that has on their interests, or take a balanced interest across the whole business. They will tend not to be resourced or sufficiently informed to be effective in their monitoring role. Individually they have no real influence on the firm and, for reasons already outlined, may not be motivated to act. Collectively they potentially have some influence (through their ability to vote at AGMs etc), but in some cases the ability to act collectively is constrained by restrictive articles, limited access to information, and difficulties in establishing contact among members. The scope for effective collective action is also hampered by sometimes-conflicting interests of Members.
- **FSA** is guided by the regulatory objectives set out in the Financial Services and Markets Act 2000. It has an interest in corporate governance to the extent that it impacts on the core purposes of the regulator, but is not interested in corporate governance *per se*. FSA has wide-ranging information gathering powers for regulatory purposes, but there are limits on how much information it is able to publish.
- **IFAs** in theory (sometimes limited in practice) survey the relative merits of different products that are available so as to advise customers, but are also influenced by commission levels. There are potential agency costs because of this. Even some larger IFAs devote relatively limited resources to this activity. On the other hand, some IFAs evidently do engage in extensive monitoring on behalf of actual or potential clients. Of course, IFA monitoring does not occur with firms who do not sell through IFA: Equitable Life was a case in point. It might also be the case that IFAs are wary of recommending the products of smaller firms perhaps because of the costs of monitoring.
- **Journalists/commentators** publish information and analysis of general interest and value. This tends not to be systematic or well resourced. They have no real information-gathering role so their monitoring tends to be based on publicly available information.
- **Rating agencies:** ratings (of firms' financial strength and their debt) are provided to paying customers. Corporate governance rating is still in its infancy. They have no incentive to rate firms (particularly smaller firms)

where there is no market for their paper and where relevant debt is not issued in the market.

- **Other life mutuals:** The sector is not cohesive, and there is no real evidence of any great motivation to monitor the activities of others, except as part of general monitoring of competitors' marketing and product development. However, this might be qualified with the newly-created Association of Mutual Insurers.
- **Government** has no direct role in monitoring mutual life firms though may suffer collateral damage in the event of a major failure of one sort or another.

Given the sometimes weak incentive structures within the *Agency Paradigm*, a central issue is what can be done to enhance the strength of incentives of the various stakeholders, and to make monitoring more effective.

II. THE AGENCY PARADIGM AND CORPORATE GOVERNANCE IN PRACTICE

In this part of the report, distinctions are made between different types of firms and the governance issues that follow from the distinctions are outlined. The analysis is conducted within the general framework of the *Agency Paradigm* of which governance is a part.

8. STRUCTURE OF THE ARGUMENT

The analysis of corporate governance in mutual life offices needs to be set within a broader framework considering the special characteristics of financial firms, mutuals in general and life offices in particular. The ultimate issue is whether corporate governance principles and optimal governance arrangements are homogeneous to all firms. The argument is that they are not and that optimal governance arrangements for mutual life offices are likely to be different from those of, for instance, plc manufacturing companies. The structure of the analysis is summarised in figure 1.

In particular, financial firms have special characteristics that do not apply to industrial and commercial companies and which may influence optimal governance arrangements. Within the financial sector there are also unique characteristics of mutuals as compared to plc firms. Even within the mutual sector, life offices (which

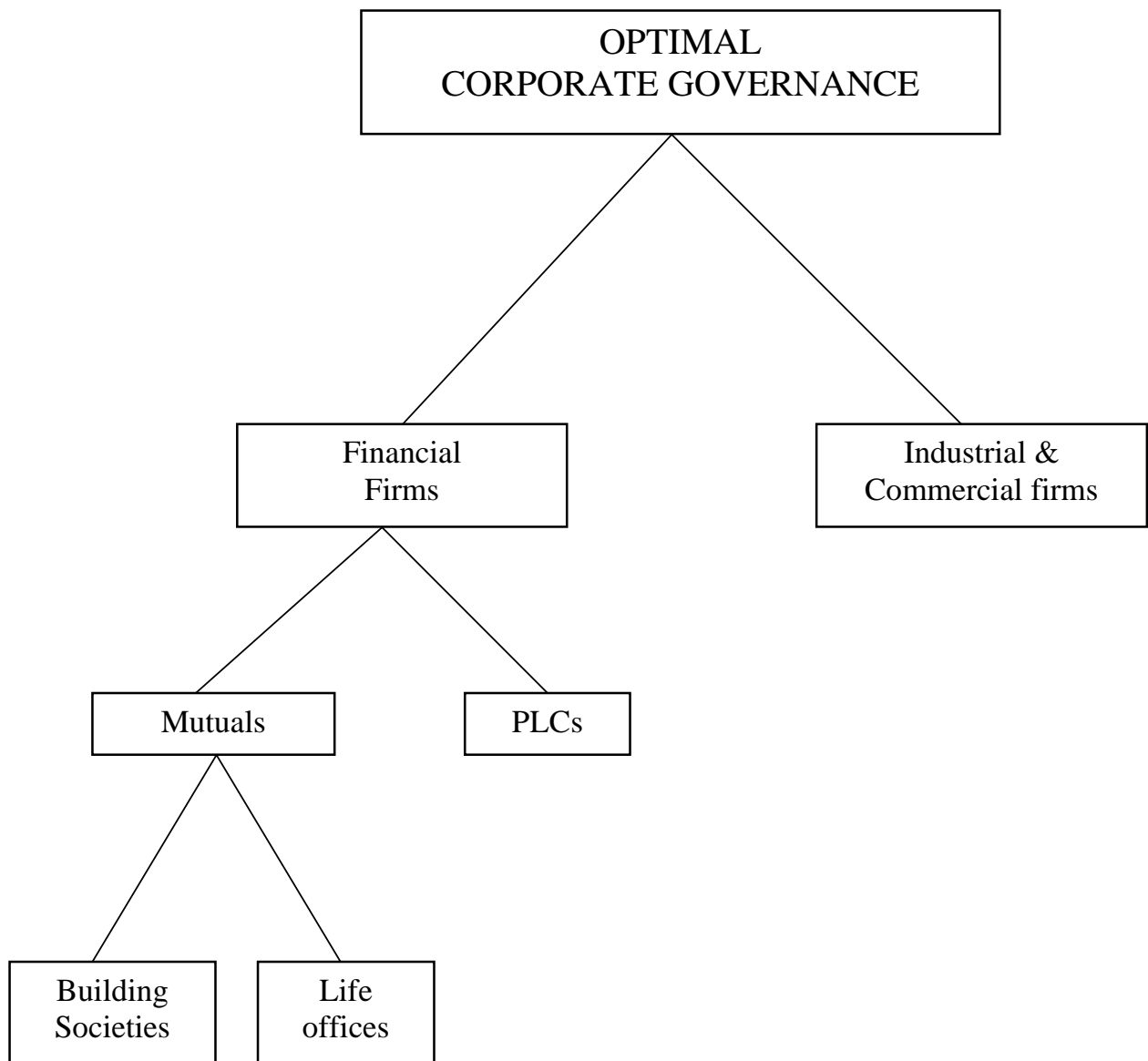
issue predominantly long term contracts to customers, and where transactions costs of exit can be high) differ from building societies (which accept predominantly short-term deposits from Members to fund long-term mortgages).

9. SPECIAL CHARACTERISTICS OF FINANCIAL FIRMS

Two distinctions have been made: between financial and non-financial firms and between mutuals and plcs. There are significant differences between financial and non-financial companies (irrespective of the distinction between mutuals and plcs) and to an extent that influences optimal governance arrangements:

- Financial firms (and especially life offices) tend to operate on a relationship rather than a transaction basis, writing contracts with long duration. This raises customer exit costs and the feasibility of control because customers are to some extent “locked in” to their contracts.
- Post-contract behaviour by a financial firm affects the value of the contract to the consumer. This creates the potential for opportunistic behaviour and gives rise to a further need for monitoring. No amount of information available at the point of purchase can guard against this potential hazard. This is part of the reason why financial services firms are subject to official regulation and supervision.
- The nature of the business is often complex and this may be especially the case with life offices.
- There is often a fiduciary responsibility towards customers in that the firm is managing the wealth of customers on a delegated basis.
- By the nature of their business, many financial firms are particularly opaque.
- Many financial firms have a systemic dimension in that the failure of an individual firm may create instability in the financial systems as a whole: in the context of banks, the social cost of failure is greater than the private cost (Llewellyn, 1999). This in turn might reduce private monitoring below the optimal amount because the external costs of failure would not enter the incentive structure of private monitors.
- Financial firms are regulated and supervised by official agencies. This may create a moral hazard and limit private monitoring if private stakeholders judge that they would only be duplicating the monitoring activity of the official agency which is perceived as having superior information.

Figure 1



In addition, there are significant differences between (some) financial and non-financial services and products. These special characteristics include:

- They are often not purchased frequently and hence the consumer has little experience or ability to learn from experience.
- There is no guarantee or warranty attached.
- Faults cannot be rectified.
- If the firm becomes insolvent during the maturity of the contract, the value of the good may be lost which is not the case with most other goods and services.
- Information on reliability is difficult to obtain.
- Value is not immediately clear at the point of purchase: the consumer cannot know if a bad product is being purchased.
- There is a lack of transparency; it is difficult to verify the claims being made by the seller.
- It is often easy for a financial salesperson to conceal relevant information and/or mislead the consumer.
- It is usually difficult to detect misrepresentation at the time of purchase.
- The product cannot be tested ahead of purchase.
- The full cost of the product may not be known at the point of purchase and it can sometimes be concealed from the consumer.
- It may be a long time (if at all) before the consumer is aware of the value and faults of a financial contract. This limits the power of reputation as an assurance of good products. Even if, in the long run, reputation is damaged by bad behaviour, consumer wealth is impaired in the meantime.

All of this means that consumer trust is more important in financial services than in most other industries.

These characteristics mean that, in practice, the transactions costs for the consumer in verifying the value of contracts (even when this can be done at all) are high. Because of the nature of the products and contracts, producers can easily mislead the consumer and this may not be detected for many years, and sometimes not until the contract matures by which time irreparable damage may have been done.

Because these differences are significant, it is likely that the optimal balance in the elements of the *Agency Paradigm* will be different in financial firms (whether mutual or plc) than in industrial and commercial companies. In particular, comparatively more reliance is likely to be placed on regulation and official supervision because the

optimal amount of supervision will be greater than the amount the private market is likely to supply.

10. MUTUALS v. PLCs: KEY DIFFERENCES

Two major differences between mutuals and plcs relate to ownership structure and capital structure. The key differences in capital structure between the two are that: (1) a mutual has no externally-held risk capital (its capital is built up from accumulated profits); (2) there are no specialist outside risk-takers which supply equity capital; and (3) leaving aside subordinated debt, the only source of capital for a mutual is the profits of the organisation. As Penrose (2004) argues with respect to life mutuals: "it is policyholders who are the source of risk capital for the enterprise" (chapter 20, Para 51). Several implications follow from this:

- (1) With a mutual, profits are either taken into reserves and add to the capital base (the case of building societies) or, in the case of life mutuals, are distributed to with-profits policy holders. A plc, on the other hand, distributes a proportion of profits to external shareholders.
- (2) In theory mutuals enjoy an "efficiency advantage" by virtue of their capital structure.
- (3) The cost of capital to a plc is a claim on revenue and exogenously determined in the capital market.
- (4) As capital is internal to a mutual (its net assets) but external to a plc, it is a source of profits to the mutual as opposed to something that needs to be served with a plc.
- (5) As the capital of a plc is tradable, there is an active secondary market in ownership claims which does not exist with a mutual.

In the case of life assurance and financial intermediaries such as building societies, there is no *necessity* to have a specialist supplier of risk/equity capital independently of the customers. It can be argued that, if external suppliers of capital (shareholders in the case of the plcs) are not *necessary*, having them stand between different sets of customers unnecessarily increases the number of stake-holders in the firm. It may also add to the complexity of agency relationships, may create potential (and unnecessary) conflicts between customers and shareholders, and raises the cost of financial intermediation. This last-mentioned arises because there is a class of stakeholders which needs to be remunerated but which is not *necessary* for the basic function of the firm to take place.

In the case of mutuals, on the other hand, there is no such evident conflict because Members are also the customers although conflicts may arise because of different interests of different members. This became apparent in the case of Equitable Life. It is also the case that not all customers are Members though this is unlikely to create substantial conflicts of interest.

Three general criticisms are frequently made of the mutual form of economic organisation (whether in building societies or life assurance offices): (1) the objectives of the mutual are difficult to define, and are ambiguous; (2) there is a serious corporate governance deficit in that the wide dispersion of ownership rights means that management is insufficiently accountable to owners, and the monitoring of managements by owners is weak; and (3) the absence of tradable ownership rights means that the management of mutuals is not subject to the disciplines of the capital market through the signal effects of share price movements, or the market in corporate ownership and control (the take-over market). In other words, corporate governance and accountability mechanisms are likely to be weak, and these are not compensated for by an active market in corporate control.

Within the financial firm sub-set, mutuals are significantly different from incorporated firms which in turn has implications for optimal governance arrangements and a greater requirement for good governance systems:

- Each Member has a non-exclusive claim to residual net worth (non-exclusive in the sense that new Members can typically join on equal terms).
- Each Member has a non-marketable claim (in the sense that it would not be meaningful to establish a secondary market for non-exclusive claims).
- Mutuals have no specialist group of shareholders and risk-takers who are remunerated separately. As noted by Lord Penrose in his report on Equitable Life: "...it is the policy holders who are the source of the risk capital for the enterprise".
- The ultimate business objectives are not as clear-cut as in the case of maximising shareholder value in a plc.
- It is, therefore, more difficult to create management incentives (such as through share options) which are aligned with owners' interests.
- Owners are also the customers.
- Mutuals cannot raise capital from the equity market (though they can, to a limited extent, from the debt markets).
- A key feature of financial mutuals is that voting rights conferred by membership are typically not proportional to the size of stake, and cannot be

accumulated by purchasing votes in a market place. Hence, the ownership rights inherent in a one-member, one-vote system are necessarily widely dispersed with any individual or group unable to build up a controlling position. Perhaps paradoxically, ownership stakes are proportional to the size of the stake but voting rights are not.

- Voice may be weak because, in some cases, dissatisfied Members have the easier option of withdrawing funds and business though this may be limited in the case of life offices because of the long-term nature of contracts and high exit penalties.
- Exit by Members diminishes the volume of funds available to the business, and can consequently be a more powerful discipline on management than the sale of shares in a plc.
- The absence of individual large shareholders who have an incentive to monitor and control. Membership of mutuals is highly dispersed (a large number of small owners) and there is no concentration in ownership stakes with the result that the incentives, expertise and ability to exercise voice are severely constrained. Blair (1995) argues that institutional shareholders in plcs have economies of scale in monitoring and gain experience and expertise through monitoring many firms.
- Incentives for owners to exercise monitoring and control are weak as the costs of doing so are prohibitive and out of proportion to the value received: in effect, a 'free-rider' argument applies.
- The absence of individual large shareholders who have an incentive to monitor and control.
- In the case of a plc, the shares have a market value which is immediately observable and known to all with a continuous re-valuation of the company. This is not the case with a mutual as there is no market in ownership claims and hence there are no price signals to guide management and alert owners and other stakeholders.
- With a plc, ownership rights are tradable and immediately realisable at any time; owners can liquidate ownership claims by selling them at a known price on the stock market. Again this is not the case with a mutual.
- There is no effective market in corporate control in the mutual sector as there is no externally held capital and no tradable ownership rights that can be bought in a hostile bid.
- The owners of mutuals (Members) are in general non-expert in the affairs of the firm which limits the effectiveness of traditional corporate governance mechanisms.

- It is probably also the case that Members of mutuals do not know they are the owners and have ownership rights that can be exercised. The generality of Members think of themselves as customers rather than owners and their concerns are those of customers and not owners.

All this means that there is ample scope for mutuals to be inefficient and to adopt hazardous behaviour. There are, therefore, potential agency costs in mutuals deriving from weak Member control. Members in a mutual do not have the same ownership rights as do shareholders in a plc. However, this general conclusion needs to be qualified as, in practice: (i) there is no systematic evidence that these agency costs are significant, (ii) there is no evidence that they have adversely affected the efficiency and performance of mutuals (on the contrary, mutuals often exhibit superior performance), and (iii) equally, there are agency costs in the plc which are similarly not perfectly addressed.

External disciplines on life mutuals work differently compared with those on plcs and there are more impediments. This can be considered within the framework of the *Agency Paradigm* outlined above:

Member voice

A key issue in all corporate governance arrangements is the extent to which stakeholders are able to influence management through voice. Several considerations can be highlighted

- Large shareholders tend to have more influence than mutual Members (and small shareholders) due to a concentration of voting power and better resourcing. This may not be the case, however, in smaller mutuals with good arrangements for involving Members.
- On the other hand, Members of mutual life offices, particularly those with longer-term policies, may have a greater incentive than shareholders in companies to make their voice heard because the exit route is more costly and cumbersome.
- Voting rights are not proportional to the size of stake which means that incentives are weak.
- Company law and listing rules prescribe issues on which shareholder votes must be taken and the way in which voting is conducted. Practice varies among life mutuals, but in many cases less influence is accorded to Members.
- The dispersed ownership structure of all mutuals makes it difficult for Members to form coalitions.

- The effectiveness of voice is severely constrained by lack of expertise in the diffused membership.

In general, the voice of Members of a mutual is likely to be less powerful and influential.

Exit

In the standard exit-voice dichotomy, an alternative to voice is exit whereby stakeholders withdraw from the firm. It is relatively easy for shareholders to exit, particularly small shareholders (though it may be more complicated for larger shareholders) compared with mutual Members who often have longer-term contracts. Also, Members tend to have access to less information on which to base voice decisions and hence might find the exit route more suitable. However, there are costs to exit and a later section notes that, because of the long-term contracts involved, exit costs are likely to be higher in life offices than in building societies.

Market in corporate control

A major disciplining mechanism in the plc sector is the take-over market which amounts to a market in corporate control. The current value of a company (based on expected future earnings) is reflected in the share price in the market. If a different set of managers judges it can extract a greater stream of future earnings, it is able to purchase the shares from existing holders at a bid premium. There is no such mechanism in the case of mutuals in that, while mutuals can merge, because of their particular capital and ownership structure, there is no scope for hostile takeovers. This means that the market in corporate control is likely to be considerably less effective in mutuals than in the plc sector. However, to some extent the threat of Members' demand for conversion from mutual to plc status could, under some circumstances, act as a surrogate for a market in corporate control although, in practice, pressure for conversion has often been initiated by the management of mutuals. In addition, it is possible for a building society to convert to plc status in order to be immediately purchased by another company as was the case with the Bristol and West Building Society at the point of conversion when it was bought by Bank of Ireland.

Corporate governance arrangements

In the final analysis, substantial emphasis needs to be given to effective corporate governance arrangements. The Combined Code is designed for listed companies. The listing rules require quoted companies to "comply or explain". However, no such requirement is made of life mutuals, though FSA rules include an adapted code for building societies. Furthermore, disclosure of information that is required of listed

companies in the listing rules and under the Companies Act does not apply to mutuals.

A later section outlines the extent to which the Combined Code can be applied to mutual financial firms in general and life offices in particular.

(e) Regulation

A central theme has been that there may be a trade-off within the *Agency Paradigm* in two respects. First, weakness in one area (e.g. corporate governance) might be compensated in other areas (e.g. active market in corporate control). Secondly, it might be necessary to engineer such compensation. One such area is regulation which can be used to offer protection to stakeholders in the absence of effective protection from other sources. With respect specifically to governance arrangements, regulation might serve to correct for failures elsewhere or alternatively require certain governance arrangements to be put in place. Thus, in some circumstances, though not in all, weaknesses in the *Agency Paradigm* (e.g. in voice) can be offset or alleviated by regulatory intervention designed to protect stakeholders.

FSA regulation does not, in general, distinguish between mutuals and plcs, though there are some specific rules in relation to building societies and friendly societies. In general, while the FSA does not distinguish between mutuals and plcs in its capacity as supervisor, it does perform certain mutual-specific functions (such as acting as a registry) that are in effect carried over from the previous regime.

For many reasons (see Llewellyn, 1999) financial firms trend to be more closely monitored and regulated by official agencies than are firms in other industries. However, regulation may have the unintended consequence of blunting the incentive for private monitors to incur the costs of monitoring. There are several possible reasons for this: (1) the regulator might be perceived as having superior information, (2) private monitoring might be viewed as only duplicating what is already being done (the free-rider problem), (3) official agencies have economies of scale that are not available to private monitors, and (4) official agencies have superior expertise. The moral hazard is that this lowers the incentive for others to monitor and even take care.

The role of the regulation is typically related to the protection of orderly markets; and the fair treatment of customers/policyholders. However, in terms of the trade-offs being discussed, it only partly replaces the benefits of good corporate governance

from other sources. Specifically, it cannot compensate for the absence of an effective Board which can encourage a management team to innovate and embrace change and to engage in calculated risk-taking for the ultimate benefit of the institution. This responsibility lies outside the scope of a regulators' remit and, furthermore, is antithetical to their natural risk aversion.

There remains the issue of whether regulatory intervention has a role in enhancing corporate governance arrangements in both mutual and plc financial firms.

13. GOVERNANCE ISSUES IN MUTUALS

A starting point in governance arrangements is the issue of ownership. This is clearly defined in the case of plcs in three respects: in terms of legal definition, in practice (in that there is a market in ownership stakes), and in terms of the separation of owners and customers. This leads to the objectives of companies being, to varying degrees, the maximising of shareholder value. Sternberg (2004) emphasises the role of corporate governance in protecting the property rights of owners. The position is nowhere near as clear, however, in the case of mutuals:

- With-profits policy holders, for instance, may own their policies (which gives them membership of the mutual) although it is less clear that in any real sense they are “owners” of the mutual.
- In what sense are there real ownership rights if there is no mechanism to sell them?
- Voting rights are not proportional to the size of the Member's stake in the mutual.
- A mutual might also consider the interests of future Members and in this sense the managers of the mutual might be said to act as trustees.

On the other hand, current Members have the right in some circumstances to vote for conversion to plc status, and the residual value on conversion or winding up accrues to current Members. Nevertheless, there remains a degree of ambiguity.

It was stressed previously that agency problems are likely to arise in any large organisation (financial or non-financial) where there is a distinction or separation between the decision-making and risk-bearing functions. In such organisations, the decision process is generally conducted by professional managers whose objectives are typically different from those of the residual claimants – such as equity shareholders in plcs and Members in mutual building societies (Smith, 1904; Berle and Means 1932; Jensen and Meckling 1976; and Fama and Jensen, 1983). The

traditional view, as epitomised by the managerial theories of the firm, however, was that these agency problems are likely to be more severe in financial mutuals than in plcs as owners in the latter can build up control by accumulating shares and thereby increase their voting rights.

A typical characteristic of mutual financial institutions is that ownership claims are severely attenuated. Each Member has a non-exclusive and non-marketable claim to residual net worth. The claim is non-exclusive in the sense that new members can typically join on equal terms. In the case of building societies, for example, the reserves of the Society will have been accumulated over many years from the profits contributed by previous Members. Nevertheless, the 'notional' ownership of this residual net worth will rest with the current Members with new Members being able to join on equal terms simply by, for example, opening a share account. It is in this context that building society Members have a non-exclusive claim on residual net worth.

The claims on residual net worth by equity shareholders in plcs, however, are explicit and marketable. Furthermore, a new residual claimant must 'take over' the claims of existing shareholders by buying shares on the open market and the value of the residual claim is reflected in the share price. Similarly, in the case of additional equity issues, the most common form is by rights issues in which existing residual claimants (current equity shareholders) are offered the option of buying additional shares in some proportion to their existing holdings (e.g. 2 for 1) at a specified price. It is in this context that equity shareholders have both a marketable and exclusive claim on residual net worth in plc institutions which contrasts markedly with the position of the notional residual claimants of mutual financial institutions.

The traditional view of agency problems in financial institutions has tended to focus on the direct control (or lack of control) exerted by owners (risk bearers) on managers. This form of control is typically observed to be *potentially* strong in plcs due to the fact that voting rights are proportional to the value of shareholdings and hence institutional shareholders can, in principle, exert a powerful influence. It is also typically argued that the fact that shares are tradable gives rise to a potentially powerful market for corporate control. In turn, this can be argued to exert a powerful influence on poor management as they face the threat of a takeover. In contrast, neither of these mechanisms is present in mutuals. Hence, this contrast has fostered the view that agency problems will tend to be more severe in mutuals.

The fact that mutual owners have only limited effective means of directly influencing decision takers does not mean that agency problems are not addressed but rather that they may be effectively addressed via alternative control mechanisms.

Because of all the properties of the mutual firm outlined earlier, mutuality raises specific corporate governance issues and the role of governance within the overall *Agency Paradigm*:

- Corporate governance is less clearly defined in mutuals partly because the firms' objectives are less clearly defined. Most of the thinking to date, and associated guidance, is based on the stock company model.
- To date, only listed companies are obliged to adhere to the Combined Code or explain why they do not.
- Transparency is a particular issue:
 - there is no clear "bottom line" objective for mutuals. The objective-setting and performance measurement are less straightforward;
 - as a consequence, conflicts of interest between managers and owners in strategic decision making are less easily identified;
 - Management incentives are also more complicated – "stock-option" type incentives (which align the interests of managers and shareholders in plcs) cannot be deployed in mutuals.
- In the case of plcs, major investors are systematically informed by senior management about developments within the company, its performance and planned strategy. Many companies have Investor Relations departments. This sometimes amounts to consultation with large shareholders. Large institutional shareholders are also able to take the initiative by demanding private meetings with senior management. Given the dispersed nature of ownership, this is clearly not feasible in mutuals.
- Plcs are legally required to make public price-sensitive information about the company.
- Ownership voice is relatively weak, particularly in larger mutuals, due to their highly dispersed ownership, the relative difficulty members face in forming coalitions, and the absence of institutional shareholders.
- A depositor (share investor) at a building society has a debt contract with the Society where the rate of return is not immediately determined by the performance of the Society. However, this must be qualified to some extent. Firstly, a more efficient Society might be able to offer better terms in which case there is an incentive for Members to monitor. Secondly, in some cases (e.g. with-profits life assurance contracts) there is a direct link between the

firm's performance and efficiency and the rate of return earned by the Member.

- Unlike the case of mutuals, the financial interests of equity holders in the efficiency of managers of plcs is proportional to their share ownership and is direct since, in theory, the value of shareholder claims is linked to the company's profitability. This suggests that large institutional shareholders have a strong interest in monitoring and influencing the companies in which they have invested.
- As noted above, while mutuals are subject to the discipline of exit by their Members, and compete alongside plcs in product markets, in other respects market disciplines on mutuals are not as strong as they are for plcs:
 - there is no effective market for corporate control;
 - mutuals are not subject to the stock market discipline of the price of their equity and hence the cost of capital is a powerful discipline in the plc sector;
 - mutuals are not rated systematically by rating agencies;
- Individual ownership rights are small and, therefore, the Members' costs of monitoring may be disproportionately high relative to the benefits, and there will be none of the economies of scale enjoyed by institutional investors in plc firms.
- Commentators and potential customers are not as well informed about mutuals' governance or performance - the information publication requirements on mutuals are less than they are for comparable plcs.

Some of the mechanisms within the *Agency Paradigm* are potentially less powerful within mutuals than plcs which is why it is sometimes alleged that the corporate governance deficit is more serious in mutuals than in plcs. However, as argued in the next section, there may be offsets.

14. MIGHT GOVERNANCE BE SUPERIOR IN MUTUALS?

Emphasis has been given to the many weaknesses within the *Agency Paradigm* with respect to mutuals. However, it can be argued that mutual financial institutions are better able to address some agency problems than are their non-mutual counterparts. Five issues are considered: (1) the unique nature of the residual claim; (2) the exit option is potentially more powerful; (3) absence of capital market as a source of capital; (4) absence of shareholder/creditor conflicts, and (5) governance arrangements.

Unique nature of residual claim

This advantage relates to the unique nature of the residual claims in mutual: specifically, that they are redeemable on demand, e.g., building society shareholders (investors) can simply withdraw deposits. Fama and Jensen (1983) point out that:

"The decision of the claim holder to withdraw resources is a form of partial take-over or liquidation which deprives management of control over assets. This control right can be exercised independently by each claim holder. It does not require a proxy fight, a tender offer, or any other concerted take-over bid. In contrast, customer decisions in open non-financial corporations and the repricing of the corporation's securities in the capital market provide signals about the performance of its decision agents. Without further action, however, either internal or from the market for take-overs, the judgement of customers and of the capital market leave the assets of the open non-financial corporation under the control of the managers" (p 318).

Exit potentially more powerful

The property rights literature suggests that the usual emphasis on factors such as: limited voting rights, poor attendance at AGM's, lack of owner Members on the board of directors, etc, in respect of mutuals is misplaced. In practice, as potential Member withdrawals imply a partial liquidation in a mutual organisation, this should generate a strong incentive to supply financial services on competitive terms and to provide a high quality of service (especially in a highly competitive environment). In this context, Fama and Jensen's argument can be seen as an extension of the Hirschman (1970) *exit-voice* dichotomy. In mutual organisations, depositors/owners typically exhibit little Member *voice* (for the reasons outlined previously) but rather can exercise the easy and costless option of *exit*. In other words, it is easier and less costly for a Member simply to (almost costlessly) withdraw business (e.g. a deposit) and transfer it to a competitor than to seek to change the behaviour of the firm. This is a powerful discipline and is in some senses a more direct threat to managers since, as was emphasised in an earlier section, when a depositor withdraws funds the capacity of the mutual is immediately reduced, whereas the sale of an equity stake in a plc does not immediately influence the capacity of the firm though the share price might fall. Thus, if equity stakeholders in a plc sell their ownership stake on the stock market, this does not remove assets from the control of the management of the company. Hence, while shareholders in plcs can use the *exit* option, they could find it disproportionately expensive if other shareholders do likewise thereby deflating capital values. Accordingly, shareholders might opt for *voice* rather than *exit*.

In principle, therefore, in highly competitive markets, inefficient management of assets by the managers of deposit-taking institutions leads to the assets being

withdrawn from their control. This is particularly significant given that, in practice, the small number of large deposits tends to be the most volatile part of the total.

Absence of capital market option

An obvious control mechanism in financial mutuals is that mutual organisations traditionally do not have access to external equity finance and this makes them more reliant on retained profits for growth. If managers have growth maximisation as a primary objective (there is empirical evidence of links between growth and management remuneration, Ingham and Thompson, 1995) this will be consistent with profit maximisation (or at least with a strong profit motive) providing that capital adequacy ratios are potentially binding.

The capital structure of mutuals is such that the almost exclusive source of capital is retained profits. This implies that, not only is it more difficult for a mutual to expand through the injection of external capital, business mistakes that have the effect of destroying capital cannot be offset by external injections of capital. This might make mutuals more risk-averse than plcs because mistakes cannot be so easily rectified.

Absence of shareholder/creditor conflicts

The debate over relative agency costs in mutual and plc financial institutions tends to focus on what may be termed standard agency problems, i.e., problems associated with the separation of decision making and risk bearing functions and manifested in problems such as management slacking and perquisite taking. A further agency problem, however, relates to the potential conflict between the holders of debt contracts and the holders of equity. Specifically, the nature of the debt contract dictates that if a risky (*ex ante*) investment produces high (*ex post*) returns well above the face value of the debt, equity holders will capture the gains while debt holders receive only their fixed contractual payments. If, however, the investment fails then, due to their limited liability, equity holders will face only limited downside risk while debt holders will face the same downside risk without any compensating upside potential. Thus, shareholders have all the upside potential of risk behaviour but only a limited downside loss, they may have greater incentives to encourage the firm to take more risk than do debt holders in the firm.

It follows that equity holders may have an incentive to see the firm investing in highly risky projects even though they may be value-decreasing for the firm, and this tendency may be exacerbated if equity investors have highly diversified portfolio holdings. This effect, generally referred to as the “asset substitution effect”, is an

agency cost of debt financing in plcs and is frequently neglected in the plc *versus* mutual debate. Indeed, it can be argued that the presence of external shareholders in plc financial institutions can add a further dimension to the agency problem by virtue of the potential conflict between the owners (equity shareholders) and depositors/customers. For example, equity shareholders may prefer a higher risk profile for the institution than would debt holders due to the former's limited liability. Clearly, in financial mutuals this particular aspect of the agency problem is absent as owners and customers are one and the same. As mutual owners have no direct claim on profits they have no incentive to prefer risky activities. This conclusion is modified to some extent in the case of Members having with-profits policies.

One parallel to this within the life mutual environment is that, in the pursuit of growth at a time when with-profits products are in decline, there is a strong temptation to grow the non-profit part of the business. Although this may yield profits that accrue to the reserves of the entity, the net effect over time is to raise the operational gearing of the enterprise from the point of view of the with-profits policyholders: as their proportion of the business mix declines they become more vulnerable to potential swings in performance of the non-profit business. This can be further accentuated if the actual number of with profits holders is also declining because maturing policyholders are outnumbering new entrants. This is a major governance issue for non-executive Board members to monitor because it is potentially an area where management's interests in a growing company might diverge from Members' interests.

Governance arrangements

It is sometimes the case in practice that mutuals seek to overcome the weaknesses of some external arrangements by applying alternative mechanisms for internal governance. These include, for instance, a higher proportion of Non-Executives on the Board of Directors, greater use of Board committees compared with the norm for plcs; fewer business links with companies (O'Sullivan and Diacon, 1996), and a greater likelihood of having remuneration committees than is the case with plcs (O'Sullivan and Diacon, 1996). A number of researchers have sought to examine whether mutual insurers utilise alternative mechanisms of governance to compensate for the absence of capital market discipline. O'Sullivan and Diacon find that mutuals do tend to exhibit greater internal governance characteristics than do plcs.

15. LIFE OFFICES ARE DIFFERENT

In terms of figure 1, earlier sections have considered how financial firms are different from non-financial firms irrespective of whether they are plc or mutual, and also the key differences between mutuals and plcs in the finance sector. The final stage is to consider the extent to which life offices in the mutual sector are different from other mutual firms and notably building societies. There are specific issues in relation to life mutuals:

- Exit tends to be more difficult and more costly for customers than it is from other financial mutuals because of imposed penalties.
- Contracts tend to be very long-term.
- The business that life mutuals conduct tends to be complex and opaque (particularly contracts based on with-profits formulae).
- Post-contract behaviour (including non-contractual discretion) can have a significant impact on the value of long-term contracts, which can be hazardous given high exit costs.
- Life mutuals are not a legally homogenous group. They are constituted under a number of different statutes (Companies Act, Friendly Societies Act, Industrial and Provident Societies Act and private acts of Parliament). There is consequently (and in contrast to building societies) no comprehensive legal lever to influence corporate governance.
- Members are not homogenous. Their relationship with the firm is contractually based, and there may be conflicting interests between different groups of Members. This was demonstrated starkly in the case of Equitable Life and the different interests of those Members who did, and those who did not, have guarantees.

In the context of Belgium, the same distinction is made by Devriese et al (2004) who argue: “Exiting, however, is easier for depositors than policy holders”. They go on to argue, perhaps optimistically in the case of mutuals at least: “Therefore we can expect that depositors exert discipline by voting with their feet, while insurance policy holders have an incentive to control ex ante”. A distinction that is peculiar to mutual life offices is that they need to consider the interests of both current and future Members.

17. GOVERNANCE MORE IMPORTANT IN MUTUALS

As discussed above there are several components to the *Agency Paradigm*. We have argued that there can be trade-offs within the paradigm in that lack of power and

effectiveness in one dimension can be compensated by stronger elements elsewhere. Previous sections have discussed some of the weaknesses within the *Agency Paradigm* with mutual financial firms. It is for this reason that having powerful, effective and robust internal corporate governance arrangements can be more important in the case of mutuals than with plcs. Mutuals may be said to be Member-owned but there is a question about whether they are effectively Member-controlled.

Bringing together the arguments of previous sections we can summarise the general weaknesses within the *Agency Paradigm* with mutuals and, therefore, why internal corporate governance arrangements are particularly important:

- Member voice is weak because of weak incentives to exercise voice, dispersed ownership making it more difficult to form coalitions, small individual ownership states thereby limiting the potential benefits of exercising voice, lack of necessary expertise, member inertia, the costs of exercising voice, free-rider arguments, etc.
- Members are often unaware they are effectively owners of their mutual rather than being perceived exclusively as customers.
- Members may be unaware of their ownership rights.
- Exit costs can be high most especially when long-term contracts are involved.
- There is no market in ownership claims.
- The absence of capital market discipline.
- The absence of an effective market in corporate control.
- Absence of clearly-defined objectives of a mutual equivalent to shareholder value in the plc sector.
- The absence of listing requirements and the disclosure requirements that go with them.
- Lack of incentives for rating agencies to monitor mutuals who do not issue market debt.
- Greater difficulty of aligning incentives of managers and owners.

These factors suggest that arguably effective corporate governance arrangements might be required more decisively in mutuals than in companies.

Corporate governance arrangements are therefore particularly important in the case of mutuals. And yet, in some cases they are weak. Birchall (2001), for instance, argues as follows: “The mutuals, in common with mutuals the world over, long lost touch with their members, treating them merely as customers and playing down their democratic rights to be uninvolved”. This is a central problem: both Members

themselves and the management of mutuals have come to view Members as customers rather than owners, although at least some building societies have started to recognise the significance of customers also being Members.

It is generally the case that Members of mutuals are not in practice active in governance arrangements irrespective of their legal rights: there is usually only a very small attendance at AGMs, it is difficult for Members to communicate with the managers, apathy is often a characteristic, it is not clear that Members regard themselves as “owners” with ownership rights, Members are usually subject to inertia, the costs of exercising rights are often high, Members may feel they have insufficient understanding of the issues, and “free-rider” strategies are often rational. In which case, while mutuals might be “mutually owned” they are not “mutually controlled”. Without Member involvement a governance deficit emerges.

However, in the building society sector at least initiatives have been taken by some Societies to enhance Member involvement by, for instance, the creation of Member Panels, Member Parliaments to facilitate communication between Members, roadshows to enable communication between Members and managers, membership magazines to communicate information, Member meetings, and Member Directors. Many Societies have taken measures to enhance the engagement with Members. Similarly, in the Co-operative retail sector, a Code of Best Practice was issued in 1995 (subsequently revised). A total of 42 requirements are outlined and this includes a requirement that Directors of Co-operative Societies must ensure that their Society conforms to the governing principles of the Code.

18. THE COMBINED CODE ON CORPORATE GOVERNANCE

The Combined Code on Corporate Governance (issued in July 2003) and which superseded the code produced by the Hampell Committee, sets out core principles and guidelines for effective corporate governance. Its unique focus, however, is on listed companies and was not focussed specifically on financial firms and was not designed to focus on the particular characteristics of financial mutuals. The Combined Code contains seventeen Main Principles (summarised in the Appendix to this paper) plus a large number of supporting provisions to each of the Main Principles. The FSA requires all listed companies to make a statement of their compliance with the Code. Mutual life offices are not under the same obligation.

The key issue is whether the provisions of the Code should apply to mutual financial firms and life offices in particular, or whether mutuals are sufficiently different to warrant a dedicated approach. The conclusion here is both: the generality of the Code's provisions are applicable to mutual financial firms and such firms should adopt the Code. However, some elements of the Code are not applicable (e.g. references to consultations with institutional shareholders) and many of the core principles need to be modified in the case of financial mutuals.

On the basis of the analysis in earlier sections, each of the Main Principles of the Combined Code (see Appendix) are briefly considered in turn with respect to their applicability to mutual financial firms in general and life offices in particular.

Principle 1: This is directly applicable without modification.

Principle 2: This is particularly important for mutual financial firms given the potential weakness of member voice and other components within the *Agency Paradigm*.

Principle 3: This relates to the balance between Executive and Non-Executive Directors on the Board. Our judgement is that, for similar reasons as Principle 2 and because of the relative weakness of some of the other elements in the *Agency Paradigm* discussed above, it is desirable for the ratio of Non-Executive to Executive Directors to be higher in mutuals than in plc firms. In fact, in the building society sector this is generally the case in both building societies and mutual life offices as evidenced by the Review Team's research (para. 4.13). In this regard, there is an important distinction also to be made between Non-Executive and the Higgs Report definition of "independent" directors.

Principle 4: This is directly applicable without modification.

Principle 5: Given the technicalities involved in many aspects of a financial firm's business, it is particularly important that Non-Executive Directors have access to independent external advice and that they have the unfettered right to seek such consultancy advice on behalf of the Members so that they are able to effectively discharge their duties in focussing on Members rights. The seeking of such advice should not be interpreted as a lack of confidence in the management of the company or of the Executive Directors of the firm. Non-Executive Directors are ultimately accountable to the generality of Members of the mutual and they have a duty to

ensure that they are satisfied with the information and interpretation being given to the Board by the executive.

Principle 6: This is directly applicable without modification.

Principle 7: This is directly applicable without modification.

Principles 8 and 9: These relate to executive remuneration. It is one of the principles which could be problematic in a mutual at least in terms of the way the Combined Code describes the issue. The principle includes the requirement that: “directors’ remuneration should be structured so as to link rewards to corporate and individual performance”. On the face of it, this seems unexceptional. However, two problems emerge. Firstly, compared with a plc where shareholder value is the ultimate focus and business objective, the objectives of a mutual are less easily defined and measured. There is, therefore, a much greater degree of ambiguity in linking executive remuneration to the performance of the firm. Secondly, the principle that “its principal shareholders” should be consulted on such issues is clearly not relevant as, unlike with many pls, ownership is very dispersed and there are no “principal” owners. This places a greater responsibility on Non-Executive directors to ensure that the remuneration policy is appropriate for the maintenance of Members’ interests. However, there is no implication in this that Executive directors of mutuals should be remunerated at a lower level than those in plcs. The principles should, however, be transparent.

Principle 10: This is directly applicable without modification.

Principle 11: This is applicable to mutuals if “shareholders’ interest” is replaced by “Members’ interests”. However, even then it is more problematic than in a plc for three main reasons: (i) because: “Members’ interests” are less easily defined than in a plc where the focus is on a fairly straightforward measure of shareholder value, (ii) unlike with shareholders, there is no clear distinction between Members and customers, and (iii) the interest of different Members may be in conflict whereas this is seldom the case in plcs.

Principle 12: This is directly applicable without modification.

Principle 13: This relates to the importance of maintaining a dialogue with shareholders. This is equally relevant with Members of a mutual. However, in

practice, and because of the dispersed nature of the ownership of a mutual, the practical problems are more formidable. It is common for senior management of plcs to make presentations and seek comment from the firm's principal shareholders. This is clearly less feasible with mutuals. However, this does not detract from the importance of finding mechanisms to communicate effectively with Members and also to create mechanisms for Members' views to be put to the management and Board. This is probably the crucial and most difficult aspect of the Code when considering its applicability to mutuals. The Principle also states "the Chairman should ensure that the views of shareholders are communicated to the Board as a whole" and that the Chairman "should discuss governance strategy with *major* shareholders" (italics added). This again distinguishes the mutual from the plc in that there are no "major" shareholders in mutuals. On the other hand, Member Panels could be regarded as playing a similar role to institutional shareholders.

Principle 14: This is directly applicable without modification.

Principles 15, 16 and 17. Not applicable as there are no institutional shareholders.

Clearly, while the general ethos of the Combined Code is applicable to mutual financial firms, and that there should be a strong presumption in favour of conforming to it, there are sufficient special characteristics of mutuals that require, at the very least, the Code to be modified. The author's view is that these are sufficiently strong that a dedicated code for mutuals should be constructed though it would draw heavily on the Combined Code for listed companies. It is not sufficient to substitute "Members" for "shareholders" in the drafting of the Code.

19. THE BOARD

The general role and importance of Boards, and in particular the composition as between Non-Executive and Executive Directors, are universal and have been addressed at great length in many recent reports and above all in the Combined Code. The arguments are not repeated here. However, most public discussion and reports have focussed on the plc model and comparatively little attention has been given specifically to the special position of mutuals. Because of the features of mutuals outlined in earlier sections, the role of the Board in monitoring management is arguably a more central feature of good corporate governance in mutuals than in plcs:

- the absence of an effective market in corporate control,
- Member voice is weak,

- the lack of distinction between owners and customers,
- corporate objectives are less clear in the mutual as there is no immediate parallel to the concept of shareholder value in plcs,
- there may in practice be weak accountability to Members compared with that to shareholders in plcs,
- there can be no external injection of capital in the event that capital is destroyed through hazardous business strategies and behaviour,
- public disclosure requirements are often less demanding in mutuals,
- consultation with Members tends to be less than with large shareholders in plcs, and
- the absence of capital market disciplining powers.

For these and other reasons, the Board of a mutual has a particular role to represent the interests of Members both as owners and customers. The role and composition of Boards in mutuals is particularly important because, for reasons outlined in earlier sections, corporate governance itself has a more central role in the *Agency Paradigm* and has a particularly powerful role in compensating for weaknesses in other mechanisms within the paradigm. In many ways, Directors (and most especially Non-Executive Directors) in mutuals have an important delegated monitoring role from Members.

Several implications might follow from this with regard to the composition and skill set of the boards of mutuals:

- the greater importance of having a non-executive Chairman,
- the need for a higher proportion of Non-Executive Directors on the Boards of mutuals than in plcs,
- the skill set of the Board needs to reflect the particular characteristics of mutuals,
- Directors also need to understand the business and the economic, financial and business environment in which it operates,
- the Board as a whole needs to have adequate skills in finance and related areas so as to be able to effectively monitor the risk management of the managers,
- there is a need to encourage greater Member involvement,
- there is a requirement for transparency and to supply information to Members in a way that can be readily understood by comparatively unsophisticated investors,

- Non-Executive Directors need to bring relevant expertise and a wider perspective which may not be available within the company or by executive directors,
- appropriate training facilities need to be made available to non-executive directors to enable them to perform their roles effectively.

In the final analysis, the Board of a mutual is responsible and accountable to Members who are also customers.

20. IMPERFECT MODELS

Comparisons are often made between mutuals and plcs in terms of performance, accountability etc. However, such comparisons are often misguided as it is not always clear on what basis the comparison is being made. Four models can be compared: (i) the **ideal** plc; (ii) the **ideal** mutual; (iii) the **actual** plc, and (iv) the **actual** mutual. In other words, it is necessary to distinguish between how institutions behave in some abstract, theoretical or ideal state, and the way they operate in practice. The ideal plc is probably the easiest to defend theoretically in that it produces clear-cut principles of objectives, accountability and control (see Llewellyn and Holmes, 1997). The ideal mutual suffers from being indeterminate: the 'balancing of members' interests' (which is often stated as the mutual's objectives) is difficult to specify.

When analysis is made of how corporate governance arrangements in plcs work in practice, we find they are far from the ideal textbook presentation. If mutuals deviate from their alleged 'ideal' form, the **actual** plc model also deviates very substantially from its **ideal** in several respects:

- Accountability to shareholders does not operate perfectly or according to the standard text-book representation; many institutional shareholders are on record as arguing that, in practice, their ability to bring inefficient management to task is limited.
- Institutional investors often do not believe they have significant control, and many believe it is not their function to exercise monitoring and control of the companies in which they hold shares. In practice, however, shareholder activism has increased over the past ten years.
- The discipline of the capital market works very imperfectly.

- Companies, in practice, are not motivated exclusively by the maximisation of share-holder value: they often follow a wide variety of objectives and are conscious of a multitude of different stake-holders' interests which at times may conflict with the interests of shareholders.
- The empirical evidence about the operation of the take-over market suggests there is no universal view that the take-over market enhances social welfare by generating efficiency gains in the way that the standard textbook would have us believe.

Thus, while the objective of the **ideal** plc may be clear (maximise shareholder value), **actual** behaviour frequently deviates from this.

While mutuals might at times be criticised for, in some sense, not behaving in the interests of Members, equally the management of plcs do not invariably operate in the interests of their shareholders by following strategies to maximise share-holder value. Both are mixed and complex in practice. To compare the **actual** behaviour of a mutual with some mythical **ideal** form of plc is clearly invalid.

Much of the debate is in terms of comparing (iv) with (i) or (ii) with (iii) dependent on the stance being taken. In the real world, (iii) and (iv) prevail. In practice, both forms operate imperfectly and, in the world of the second-best, no safe conclusions can be drawn regarding the superiority of one form over the other.

In general, and when considering consumer interests, comparing the merits of the two organisational forms is of second-order importance in the context of: imperfect versions of each; when both operate in a competitive environment, and when the two forms compete in the same markets. Many of the arguments on both 'sides' of the debate are spurious when in practice both forms operate away from their ideal characteristics.

Some analysts have argued that the two basic problems with mutuals (the weakness of monitoring mechanisms and the absence of an effective take-over market) are sufficiently serious that mutuals should convert to plc status. This view is rejected for several reasons:

- While there are clear corporate governance issues with respect to mutuals, and indeed it may be argued there is a significant 'corporate governance

deficit', it is not valid to compare the imperfect operation of mutuals with a hypothetical, perfect model of the plc.

- There are real and serious weaknesses in both corporate governance and the market in corporate control (take-over market) in the plc sector: the weaknesses of corporate control are certainly not exclusive to mutuals.
- Because of this, conversion of mutuals to plcs would not in itself solve corporate governance problems, or necessarily improve the allocation of resources in any meaningful way.
- It is also for this reason that there is a strong case for a mixed system of mutuals and plcs.
- There are also reasons to believe that, in practice, the problems of corporate governance may in some respects be less with mutuals than with plcs. A review of the literature indicates little empirical evidence to support the notion that weaknesses in corporate governance arrangements of mutuals in fact lead to inefficiencies, or management exploiting their information advantages.

In the final analysis it is competition that is the major discipline on the mutual. This is by far the most powerful discipline, most especially when mutuals and plcs are in direct competition with each other.

III. RECOMMENDATIONS

It has not been the purpose of this paper to in any way anticipate the recommendations of the report by Paul Myners. Rather, the main focus has been to establish an analytical framework in which to consider the potential governance weaknesses in mutual life institutions. Nevertheless, on the basis of this analysis some pointers to reform emerge some of which were anticipated in the Treasury Consultation Document issued in July 2004:

1. While many of the Main Principles within the Combined Code apply directly to mutual financial firms, and some others can be made to apply with only modest modification, the differences between mutuals and plcs may be sufficiently significant to warrant their own dedicated code.
2. There should be a strong presumption of compliance with any such Code whether it be a dedicated code or amendments to the Combined Code.

3. The general principle of “comply or explain” should be the norm though, as noted in the Consultation Document, this might need to be modified to fit the circumstances of mutuals.
4. There is a greater requirement in mutuals for Boards to monitor the action of executives than is the case with plcs. Weaknesses in external monitoring and direct monitoring by owners of mutuals need to be compensated by stronger internal governance mechanisms.
5. To reflect an enhanced role in protecting the interests of Members, the skill set of Non-Executive Directors is crucially important in mutuals most especially in the context of a complex business. As noted in the Consultation Document, this suggests a more systematic approach to Board construction.
6. A comprehensive review is needed of the required disclosure regime for life mutuals.
7. Individual mutuals (whether they be building societies or life offices) need to give priority to systematically considering how a dialogue with Members can be promoted.
8. All aspects of the existing Combined Code (except 15, 16 and 17) should in general apply to mutuals.
9. There should be a requirement for mutuals to issue a Statement of Compliance.
10. Public statements of practice with respect to all the key areas of the Combined Code (or any dedicated code applied to mutuals) should be issued by each life mutual.
11. Mutuals should not offer un-hedged guarantees. This is because of their capital structure which implies that guarantees to one set of Members are effectively underwritten by other Members often in their ignorance. Guarantees can, on the other hand, be designed into a mutual product provided they are covered through a matching asset/liability programme that meets the proper tests of robustness. Term assurance would be an example of a product which offers fixed guaranteed payouts under defined conditions.
12. Consideration should be given to the feasibility of creating a specialist rating agency or system for life offices. There are, however, serious constraints on this and notably the question of why would pay for any ratings. It may be that the only feasible option is through disclosure of performance and financial strength information which (as noted in para 10.10 of the Report) the Financial Services Authority is already considering.
13. Regulation should offer strong guidance on the required expertise of Non-Executive Directors and the Board generally.

14. The FSA should monitor the skill set of mutual Boards on a continuing basis.
15. Non-Executive Directors should have a right to, and resources for, independent consultancy advice on any matter relevant to the business.
16. Some large mutuals might usefully consider creating an Advisory Board composed of Members (plus expert advisers) to whom some aspects of monitoring are delegated from the generality of Members. However, care would be needed not to usurp or undermine the authority of the main Board.
17. There should be a compulsory internal audit function, (see Smith Guidance page 47 of the Combined Code).
18. Resources should be allocated by the firm for suitable and continuing training of Non-Executive Directors.
19. All Boards of mutuals should have a Risk Committee to analyse and monitor the range of risks applying to the organisation although care is needed to avoid the danger that the existence of a separate Risk Committee may produce ambiguity between its remit and that of the Audit Committee. Some analysts argue that the current reform of the monitoring of with-profits funds and the new roles of the with-profits actuary and the peer reviewing actuary during the audit process will collectively bring much greater robustness to the risk control area without overloading the Board with potentially inappropriate tasks.

In the final analysis, mutuals are owned by their Members even if that perception is not widely appreciated by the Members themselves. The purpose of any set of recommendations is to enhance the power of monitoring by Members and others.

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APPENDIX 1

MAIN PRINCIPLES OF THE COMBINED CODE

1. Every company should be headed by an effective board, which is collectively responsible for the success of the company.
2. 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.
3. The board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) so that no individual or small group of individuals can dominate the board's decision taking.
4. There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.
5. 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.
6. The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.
7. 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.
8. 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.
9. 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.
10. The board should present a balanced and understandable assessment of the company's position and prospects.
11. The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.

12. 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.
13. 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.
14. The board should use the AGM to communicate with investors and to encourage their participation.
15. Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives.
16. 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.
17. Institutional shareholders have a responsibility to make considered use of their votes.