

## Looting the Mutuels: The Ethics and Economics of Demutualisation

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### Cause for Alarm

Australians have good cause to be alarmed about demutualisation. Eighty percent of our permanent building societies and almost all our insurance societies have been demutualised. Following the only demutualisation of a credit union to date — the Sunstate Credit Union in Queensland in 1997 — it is likely that credit unions will also before long be widely targeted for demutualisation.

A feature article in the *Melbourne Age* describes the demutualisation of the Australia's largest insurance mutual, the Australian Mutual Provident Society (AMP) as 'the legal looting of 150 years of patient wealth accumulation'.<sup>1</sup> Mutuels demutualised prior to the current demutualisation of the insurance arm of the National Roads and Motorists' Association (NRMA) are reported to have had an aggregate net worth of \$21 billion, and assets under their control of \$180 billion.<sup>2</sup>

### Casualties

One major casualty of demutualisation has been the capacity for new mutuels to be formed in the confidence that they will retain their proper function of enabling their members to engage in self-help. Another has been the impoverished, dispossessed or otherwise excluded sections of the community whose interests mutuels have traditionally served. Not least, public trust — viewed by the US social scientist Francis Fukuyama as the glue which binds societies together<sup>3</sup> — has been diminished.

Compare a mutual with a shareholder-owned company. As Mark Sibree of the leading friendly society, Australian Unity, sees the society's relationship with its members: 'we are not in a position to rip them off; there's no purpose. The same people who are our customers can turn up at the annual meeting and vote'. In the words of a leading British insurance mutual executive: 'There is a difference between a business run for the benefit of policy holders and a business run for the benefit of shareholders. You put a different person first'.<sup>4</sup>

In the case of a recent failed attempt to demutualise the giant Nationwide Building Society in Britain, an estimated 600,000 of the 4.9 million members qualified to vote had joined the Society prior to the poll for the express purpose of supporting a demutualisation.<sup>5</sup> Building societies in Britain are in some instances responding to the threat to their mutualist status by rule changes requiring new members to enter into an undertaking that any windfall gains accruing to them from a demutualisation will be paid directly to a nominated charity.<sup>6</sup>

The great Standard Life mutual in Scotland is currently engaged in a £10 million campaign to fend off an attempted demutualisation. A letter addressed by the CEO to the members puts the ethical issue in a nutshell. It reads: 'You have benefited from our mutual structure and I am

asking you now to take the principled decision to preserve the mutuality and allow the next generation to experience the same benefits'.<sup>7</sup>

## **Law No Protection**

Neither Britain nor Australia has any significant legal deterrents to demutualisation. Thanks to the judgements in the Sunstate Credit Union case, and more recently in the NRMA Insurance case, it is now apparent that Australian law not only provides little protection for mutuals, but for all practical purposes fails to acknowledge their existence as distinctive entities. As Santow J noted in the NRMA case:

The Corporations Law does not anywhere refer to a mutual company. It makes no provision for the creation of such a company: s112 Corporations Law. Nor does it contain a definition of what a 'mutual' is, or articulate any principles for the management of the affairs of a mutual company.

His judgement further noted that, in the eyes of the law, mutuals are not necessarily under any obligation to provide mutual benefits as intended by their members, nor have their members any more claim on their surpluses than shareholders on company profits.

The law permits a mutual to be demutualised at any time by its current generation of members, without regard for the intentions of generations before them or the interests of those still to come. As the judgement concludes, in the specific instance of NRMA Insurance: 'Neither "mutuality principles", nor the constitution of Insurance nor the fact of there being accumulated profits derived from failures to pay rebates or carry out "mutuality pricing", constitute any legal impediment to approval of these Schemes with the associated demutualisation'.<sup>8</sup>

The question arises less of what the law imagines to be the meaning or purpose of mutuals than of whether any of either is left to them. There is no counterpart in Australian law for amendments to Canada's Insurance Companies Act in 1999 disqualifying directors, managers and employees of demutualising mutuals from benefits other than the entitlements of eligible policy-holders.

## **Perverse Incentives and Conflicts of Interest**

Unlike most British demutualisations, those to date in Australia have been due more to internal than to external predators. Many — perhaps most — are open to the interpretation that they have occurred either largely or in part because directors can count on higher fees and managers on higher salary packages following demutualisation. In some cases directors may also see demutualisation as giving rise to opportunities for them to move into lucrative senior management positions.

Consequent on mutuals having no tradeable shares, managers know that getting their hands on share options is conditional on demutualisation. A prominent — albeit resolutely anonymous — New York insurance industry lawyer believes that demutualisations have been due more to stock options than any other cause. There has been no resistance by boards or managements of mutuals in Australia to demutualisation such as by, say, the Nationwide Building Society or the Standard Life insurance mutual in Britain. Demutualisations inescapably entail massive conflicts of interest for directors, managers and professional advisers.

Had the AMP remained a mutual, its recently-departed CEO, George Trumbull would not have been on an annual salary of \$2.7 million, had entitlements to \$10 million in share options over a three-year period, or received a \$14 million payout when his contract was terminated prematurely.<sup>9</sup> In a mutual AMP it is possible that the current CEO, Paul Batchelor, would not have survived being complicit in the company's loss of \$1.5 billion consequent on its botched

takeover of the privatised Government Insurance Office (GIO). Paul Batchelor has a no less generous salary package than Mr Trumbull, including options to acquire at an excise price of \$15.93 each 1.28 million shares which his chairman, Stan Wallis, says should properly be worth closer to \$30. The total value of Mr Batchelor's options is reported to be \$20 million.<sup>10</sup>

Had the National Roads and Motorists' Association Insurance (NRMA) demutualisation bid not proceeded, stockbrokers and advisers would not have shared on so large a scale in overall outlays by the NRMA for the project totalling \$107 million.<sup>11</sup> The joint global coordinators Credit Suisse First Boston, UBS Warburg and Macquarie Bank are reported to be receiving total fees of \$17.9 million. In addition, CSFB is reported to be receiving a further \$500,000 for advice on the float, plus \$3.3 million for work on developing the demutualisation proposal. Fees for other advisers are reported to total \$10.3 million, including \$1.9 million for accounting firm KPMG and \$3.26 million for lawyers Mallesons Stephen Jaques.<sup>12</sup>

Is not the exposure of directors, managers and advisors to perverse incentives and conflicts of interest starkly obvious? May it not be that the destruction of great mutualist institutions and the dispersal of billions of dollars in hard-won mutualist capital in piecemeal parcels of a few thousand dollars means little to the demutualisers if in the process they acquire millions for themselves?<sup>13</sup>

### **Case Study 1: NRMA Insurance**

Nor have the outcomes of demutualisations been conducive to their own or the public interest. NRMA Insurance is a case in point. As a mutual, NRMA Insurance has not, like the demutualised National Mutual Life Society, so miserably under-performed as to have allowed itself to be taken over by the French insurance giant AXA. It has not like the demutualised Colonial Mutual Life Society been swallowed up the Commonwealth Bank — a bank gravely compromised like its major counterparts by its recent involvement in the notorious 'cash for comment' broadcasting scandal and currently facing investigation by the Australian Competition Commission for its alleged complicity in collusive pricing practices. It has not, like the demutualised AMP, so gravely damaged itself through its GIO takeover as to have brought about a precipitous decline in its share price and thereby given rise to speculation that it too will shortly be targeted for a takeover. Demutualisation has concentrated more power in the hands of fewer financial intermediaries, while at the same time reducing their accountability.

According to the *Australian Financial Review*, \$2 billion in value was destroyed in the GIO bid, and the opportunity costs forgone were 'well above' that figure. and 'horrendous'.<sup>14</sup> Those responsible cannot claim to have had no warning. A May, 1998, bulletin from the influential Moody's rating service notes in a prescient passage that: 'One almost universal reason that mutual insurers provide for conversion is to facilitate acquisitions of other companies. ... However, any transaction is a relatively high risk affair; unwise transactions have been known to inflict unexpected (and even serious) harm on the unprepared acquirer'.<sup>15</sup> An overall assessment of insurance demutualisations to date, by the *Financial Review*, concludes with masterly understatement that 'the transition from mutual to listed company has produced patchy performances'.<sup>16</sup>

Moreover, the strong showing of NRMA Insurance as a mutual gives the lie to claims that its demutualisation was motivated by commercial necessity or competitive advantage. Recent figures for its performance prior to demutualisation show an increase in operating profits from \$116 million to \$329 million. The CEO, Mr Eric Dodd, has stated that the group's ability to achieve so satisfactory a result in a year that included the single biggest insurance catastrophe in Australia's history was a measure of its strength. According to Mr Dodd, 'This year's strong result, in the face of such high claim activity, vindicates — in part — the decision to diversify the business of NRMA Insurance'.<sup>17</sup>

Further evidence that NRMA Insurance could not be claimed to have insuperable problems as a mutual is contained in a report which the NRMA Board commissioned from Marsden Jacob Associates and Copernican Securities. To date the Board has kept the report confidential by the simple expedient of refusing its authors an indemnity against possible legal action consequent on what the *Melbourne Age* sees as its 'incendiary critique' of the CSFB material.<sup>18</sup> As the *Australian Financial Review* has disclosed — and the NRMA board has not denied — the Marsden-Copernican Report concluded that the case for demutualising NRMA Insurance was 'essentially philosophical', with the challenges confronting the motoring and financial services solvable within its existing mutual structure.

In the view of the authors:

- ? NRMA's governance problems were not exclusive to mutuals nor were they insurmountable;
- ? The case for retention of the mutual structure rested largely on whether the board and its members saw value in retaining the objectives of mutuality;
- ? If mutuality was valued, then there was no cogent reason to demutualise;
- ? There were no tax disadvantages to NRMA's acquisition aspirations from its mutual status;
- ? NRMA was not short of capital.<sup>19</sup>

The report cited Holland's spectacularly successful Rabobank and the DeJardins credit unions in Canada as evidence that as good outcomes can be achieved by mutual as by conventional financial intermediaries.<sup>20</sup>

Moreover, the *Australian Financial Review* further reported — and the NRMA Board has not denied — that the Marsden-Copernican report had repudiated the key advice from CSFB on which the Board had relied to justify demutualisation. According to the *Australian Financial Review*, 'In the report, Marsden Jacob Associates and Copernican Securities conclude that there are negative benefits from a restructure and attack a key premise of CSFB's work, which asserted that, as a mutual, NRMA required 20 per cent more capital than other insurance companies'.<sup>21</sup> The senior business columnist of the *Age*, Stephen Bartholomeuz, has disclosed that Marsden Jacob Associates and Copernican Securities also formally advised the NRMA board that it would be in breach of its fiduciary responsibilities if it didn't seriously consider their report's criticisms of the CSFB material.<sup>22</sup>

## Meaning and Benefits of Mutualism

The hard questions about demutualisation are not being asked. Where in the NRMA controversy was proper attention given to the meaning and benefits of mutualism? Mutualist bodies such as insurance societies, credit unions, friendly societies, building societies and co-operatives reflect the principle that our key needs can often be satisfied more effectively by acting together than alone. Mutuals are usually formed so members can obtain goods and services which would otherwise be unavailable or higher priced.

Credit unions are a case in point. While Australia has had financial co-operatives for more than a century, credit unions in their modern form date from the late 1940s and early 1950s. Australians who married in those years could obtain 30-year home loans at rates of about 3 per cent. However, buying furniture or a car required borrowing from hire purchase companies — often subsidiaries of the major banks — at interest rates which were flagrantly extortionate.

As a consequence, families in outer suburban Catholic parishes got together after mass, pooled their savings and queued for loans at affordable rates. In time, their neighbours of other faiths or none at all joined in, giving rise to community credit unions and, a little later, industrial credit unions. The benefits of credit unions are so obvious that they now number some 3 million members, with assets totalling more than \$21 billion. Every member is an equal co-owner of the business, with an equal say in its affairs and equal access to its services.

Mutual insurance is no different. As a mutual, NRMA Insurance was simply a body of people who came together with the intention of providing themselves with insurance services and other financial products for lower prices than conventional commercial providers. As a mutual, NRMA Insurance was assisted in providing a better service at a lower cost by not having to pay dividends to shareholders, and also by the capital which earlier generations of its members had contributed in the expectation that it would be passed on for the benefit of generations still to come.

NRMA members might well have asked themselves whether they could in good conscience abdicate their responsibilities as, in effect, trustees for the intentions of the dead and the inheritance of the unborn. What were those of them who believed in a fair go to make of finding themselves in the company of the blow-ins and johnny-come-latelies — the so-called 'carpet-baggers' — who have qualified for membership of NRMA Insurance exclusively in order to bring about and benefit from a carve-up of the assets which others before them have created and conserved? Buying up policies in advance of the widely-anticipated demutualisation of the AMP is reported to have gained one notable carpet-bagger windfall profits totalling \$10 million.<sup>23</sup>

And what was to be made of arguments such as of the CEO of the NRMA, Mr Dodd, that the interests of past members could the more readily be disregarded because they were a minority? According to Mr Dodd, 'Nearly 70 per cent of all people who have ever been members of NRMA are currently members'. 'And since most of the NRMA's distributable wealth has been created in the latter part of the organisation's existence', Mr Dodd was reported as continuing, 'the proportion of current members who are entitled to that wealth was almost certainly greater than 70 percent. It's an amazing statistic and it makes it an even more compelling reason'<sup>24</sup>. Might not the substitution of numbers for ethics indicate a profound moral myopia?

### **Insurance Costs**

A second key issue for NRMA Insurance members might well have been what real value they were likely to receive in return for surrendering their membership entitlements. Stephen Bartholomeuz describes the savings a mutualist insurance body delivers as 'corrupting the market in which it operates'.<sup>25</sup> What this means is that the price of insurance would be much higher if the mutuals were no longer around to keep it down. Just as credit unions played a key role in stamping out the worst excesses of the hire purchase racket, so the presence of the insurance mutuals is a major factor in keeping the insurance market honest.

Significantly, since the Housing Loan Insurance Corporation became a proprietary limited company, housing loan insurance costs have risen by 30 per cent. NRMA members might have asked themselves how long it would be before the value of the 'fistful of dollars' on offer for their rights would be eroded by premium increases and a less sympathetic response in the face of hail storms, floods, fires and other natural disasters. The *Australian Financial Review* has disclosed — and the NRMA board has not denied — that, in the view of the Marsden-Copernican report, a demutualisation of NRMA Insurance 'would increase the cost of insurance to all insurance policy-holders in the key NSW market'.<sup>26</sup> Nor has it been necessary in order to hold down prices for NRMA Insurance to exercise fully the powers available to it. The demutualisation memorandum notes that premium rebates for members were withdrawn in 1995.<sup>27</sup>

### **Retargeting and Reinventing Mutuals**

A third key issue for NRMA members might well have been what wider benefits would be foregone in the event that NRMA Insurance was demutualised. Modern mutualism rejects the view that mutuals are necessarily restricted to their original services. It sees them instead as pools of community wealth which periodically require re-inventing and re-targeting in response

to changing needs, or where commercial providers deliver comparable services at competitive prices.

NRMA Insurance's capacity for reinvention and re-targetting is plain. As Ernst & Young Corporate Finance Pty Ltd acknowledge in their *Independent Financial Expert's Report* for the demutualisation memorandum:

As a result of Insurance being a mutual, Insurance members together with the wider community may potentially be in receipt of a benefit from certain services or broader activities which are undertaken by Insurance as a mutual. These services potentially include the following:

- ? community initiatives, projects or services which may benefit general insurance consumers as a whole;
- ? making of decisions regarding the payment of claims which take account of wider community issues, for example, the decision to pay claims in respect of the Wollongong floods;
- ? provision of policies to groups within the community which may otherwise not have been able to obtain insurance coverage;
- ? better level of customer service; and
- ? lower premiums.

The catch was that the board was not interested. As Ernst and Young also acknowledge: 'We are not aware of any decision by the Insurance Board to undertake, either now or in the future, some or all of the activities outlined above'.<sup>28</sup>

### **Case Study 2: the Sunstate Credit Union**

Nor when the test came were the members of the Sunstate Credit Union any more ready to defend its mutualist status. As at 30 June, 1997, Sunstate had 19,358 shareholders and a further 2,725 depositing members without shares. The reserves of the credit union — its net assets — totalled \$8.036 million. The credit union's capital adequacy ratio of 12.9% was comfortably above the minimum prudential requirement. Operating profit in 1998 was expected to increase over 1997 by 18% or \$65,000, from \$371,000 to \$436,000.<sup>29</sup>

Sunstate was a viable credit union, which could either have remained in business on its own, or preserved its mutualist character through a merger with another credit union. Alternatively, if the directors believed in good faith that the credit union was not viable, they could, in a worst case scenario, have recommended that it be wound up, and its assets shared equally among its members in a conformity of sorts with mutualist principles.

Instead, the Sunstate directors made no attempt to defend the mutualist character of their credit union or retain the benefits of mutualism for its members. Far from recommending an amalgamation with another credit union, the Board's recommendation was that Sunstate should be merged with the First Provincial Building Society, which is a publicly listed company. Instead of ensuring that the assets of the credit union were distributed equally among its members, the Board recommended a grossly inequitable distribution.

Of 4 million shares in the First Provincial Building Society offered to members of Sunstate, 200,000 were reserved for directors and 200,000 for employees. The effect was to make directors eligible for benefits roughly 300 times greater than those likely to be available to other members of the credit union. Employees also were made eligible for greater benefits than most members were likely to receive. Twenty five thousand shares were reserved for the former General Manager of the credit union, who also had an entitlement to take up such further unreserved shares as a might turn out to be available.

Most of all, members who did not wish or could not afford to take up their entitlement to shares — or were not qualifying members — were effectively denied their interest in the assets of the credit union, and received nothing whatsoever in return. Estimates at the time of the amalgamation suggest that 86% of the members of Sunstate were unlikely to receive anything in exchange for forfeiting their entitlements to its reserves, and only 14% to benefit.<sup>30</sup> That no regulatory objection to the merger was offered reflects poorly on the regulators. That the court did not feel able to intervene reflects poorly on laws and the legislature.<sup>31</sup> That individual directors instigated or were party to the merger brings into question whether they at any stage properly understood mutualism or were genuinely committed to mutualist principles.

Given that six of the seven directors of Sunstate had held office for periods in excess of twenty years and the seventh director for ten years, the question arises: on whom can credit unions rely to protect their mutualism?

### **Credit Unions Next Target**

As has been seen, there is evidence that further credit unions are already in the sights of predatory demutualisers and the corporate law, accounting and merchant banking interests which benefit financially on so massive a scale from favouring and facilitating demutualisations. The chairman of the peak body of the credit union movement, Credit Services Corporation Australia Ltd (CUSCAL), Richard Crosbie, reported to its affiliates at their annual general meeting in 1997 that:

We are aware of the existence of legal and accounting firms who are openly assessing the net worth of credit unions and promoting programs delivering short term wealth distributions even though this eliminates the credit union as a credit union. ... The Australian Financial Institutions Commission has indicated that in just one week they received at least 20 calls from interested parties who wanted to know more about the opportunities for demutualising credit unions.

As CUSCAL's general manager of movement development and business services, Graham Loughlin, now sees the situation: 'I'd be surprised if some of Australia's regional banks weren't already identifying larger credit unions whose market niche aligned with their own development plans'.<sup>32</sup>

The writing is on the wall. Australia's last significant mutuals may well shortly follow the dinosaur and the dodo into extinction. It will be too late for regrets and recrimination when the realisation finally sinks in that, like Esau in the Bible, we have sold our birthright for the proverbial 'mess of pottage'.

Canlow v, 2/12/00, NRMA Limited (Application 61), NRMA Insurance Limited (Application 67) [2000] NSWSC 82, Supreme Court of New South Wales.

<sup>9</sup> *Age*, 8/10/97 and 15/4/00.

<sup>10</sup> *Age and Australian Financial Review*, 19/5/00

<sup>11</sup> *Sydney Morning Herald*, 19/2/00

<sup>12</sup> *Australian Financial Review* 26/6/00

<sup>13</sup> See also Mathews R., 'NRMA Demutualisation' in *Journal of Australian Political Economy*, Number 44, December, 1999.

<sup>14</sup> *Australian Financial Review*, 5/4/00.

<sup>15</sup> Fliegelman A., Maloney K.W. and Riegel R.L. 1998, *March of the Mutuels — A Rapidly Evolving World: Mutual Holding Company and Demutualisation Activity*, New York, Moody's Investors Service Global Research.

<sup>16</sup> *Australian Financial Review*, 5/6/00

<sup>17</sup> *Australian Financial Review*, 3/9/00

<sup>18</sup> *Age*, 10/7/99

<sup>19</sup> *Australian Financial Review*, 12/7/99

<sup>20</sup> *Australian Financial Review*, 10—11/7/99

<sup>21</sup> *Australian Financial Review*, 12/7/99

<sup>22</sup> *Age*, 10/7/99

<sup>23</sup> *Australian Financial Review*, 4/5/00

<sup>24</sup> *Australian Financial Review*, 22 October, 1999.

<sup>25</sup> *Age*, 10/7/99

<sup>26</sup> *Australian Financial Review*, 10—11 July.

<sup>27</sup> NRMA Limited, 2000, *Information Memorandum: The Future is in Your Hands*, Sydney, NRMA, p. 75

<sup>28</sup> NRMA Limited, 2000. p. 75.

<sup>29</sup> Figures from First Provincial Building Society Ltd, 1997, *Amalgamation Assessment and Financial Information and Reports: Book 2*, Toowong, Queensland.

<sup>30</sup> Figures from Loughlin G. 1997, 'Sunstate Credit Union/First Provincial Building Society — Transfer of Engagements', in *Credit Union Services Corporation Bulletin* No. 311/97.

<sup>31</sup> *Herbert Stanley Rolfe and Ors v Sunstate Credit Union Limited and Ors* (1997) 1109 FCA. (23 October 1997)

<sup>32</sup> World Council of Credit Unions, 2000, 'Demutualisation' in *Credit Union World*, Volume 2, Issue 1, March, 2000.