PROGRESS UPDATE OF INDEPENDENT GOVERNANCE REVIEW

14 March 2014

From Paul Myners, Senior Independent Director of The Co-operative Group

Today, I am publishing a progress update of my Independent Governance Review[1], including draft recommendations that, when finalised, will be submitted for consideration by the elected membership at the 2014 Annual General Meeting. The recommendations are designed to achieve radical reform of the Group Board, while ensuring that the Group remains fully in accord with its core co-operative values and principles. In that regard, let me state clearly my firm support for co-operatives and for mutuality as a concept.

In December last year, I was invited to join the Group Board and to conduct an independent Review of the Group's governance. I set out to undertake the Review in two phases, with the first to be completed in time for the Group's AGM in May. Earlier this week, amid heightened scrutiny of the Group's governance, I was asked to share with the Board the principal recommendations under consideration.

Following that and in light of the considerable interest within and outside the Group in my proposals for reforming the Group's governance, I have decided to provide a progress update of the Review, its main conclusions and recommendations. This will allow for early consideration by all the Group's members ahead of the formal publication of my Phase One report in April.

The context for this Review

The past year has been traumatic for the Group. The massive losses caused by the near collapse of its banking subsidiary brought the entire organisation to the brink of failure. It was only due to the exceptional skill and tireless efforts of a new executive team, led by Euan Sutherland, that the Group survived. This near catastrophic loss by itself dramatically highlighted the need for the most rigorous examination of the Group's governance.

Numerous investigations have since been launched in a determined effort to learn the lessons from this corporate disaster. Externally, the Group is now subject to regulatory investigations by the Financial Conduct Authority, Prudential Regulation Authority and Financial Reporting Council. The failure of the Bank has also been the subject of Treasury Select Committee hearings, with a report of its findings expected soon.

[1] Its terms of reference are available at http://www.co-operative.coop/MynersReview/Terms-of-reference/.

In addition, the Executive commissioned an Independent Review, chaired by Sir Christopher Kelly, into the events that led to the announcement of The Co-operative Bank's capital action plan to address its £1.5bn capital shortfall.

This is the context for my own Review. As I said when I was appointed, my work is intended to be forward-looking and to provide the Group with a robust governance framework to replace the current flawed system. The Group needs governance that is fit for purpose.

In developing the Phase One Review, I have found it necessary to go further in my recommendations than I had initially envisaged. What quickly became clear in my investigation was the extent to which any set of recommendations for reform of the Board needed to be integrated with proposals for reform of the entire electoral system through which member control has been exercised. I have thus found it necessary to propose a more extensive set of recommendations at this stage than originally anticipated.

The nature of the Group's governance challenge

The Co-operative Group suffers from acute systemic weaknesses in its governance framework that over many years have gravely damaged the organisation. These failings include a series of costly strategic misjudgements that have undermined the Group's competitive position and severely eroded its capital base. The Group Board have collectively presided over losses of several billion pounds in the course of the last few years. Debt has reached levels that are no longer sustainable without the sale of treasured assets. Sale and leaseback transactions represent an expensive addiction the cost of which does not appear, even now, to be fully appreciated by the Board.

The Co-operative Group's three-tier system of elected member representation has consistently produced governors without the necessary qualifications and experience to provide effective board leadership and to monitor, challenge and provide guidance to management. This has massively raised the cost of decision-making and diminished genuine accountability throughout its governance hierarchy.

At the same time, the Group endures a significant "democratic deficit". Ordinary members have surprisingly weak constitutional rights and limited ability to influence the Co-operative Group's social mission and activities to reflect their interests and values.

Moreover, the Group's social goals agenda is insufficiently aligned and connected with the achievement of its strategic and commercial objectives. In particular, there is a need for a full audit of controls over money spent on social goals and given to affiliated bodies.

The challenge of redesigning the Group's governance

The task facing this Review has been to develop a reformed governance framework that simultaneously achieves three objectives. First, it has to produce a highly competent and qualified Group Board with non-executive directors who possess the skills and experience to exercise leadership and effective oversight of executive management who are running a business of massive scale and complexity, quite unlike any other co-operative business in the UK. Unless the Group takes urgent steps to reform its governance so that it generates sustainable economic value, it will run out of capital to support its business. Value creation is the prerequisite for value distribution to members and to the furtherance of desired social goals.

The second objective is to ensure that genuine co-operative values and principles are protected and securely embedded in the future governance structure.

The third and equally important goal is to ensure that as a customer-owned organisation, the interests of the entire membership are properly understood and promoted and their fundamental rights are respected.

Developing a governance solution that meets these criteria for success is an intricate and complex task. In the face of a massive failure of governance the need for radical reform of the Group Board is inescapable. Yet within the elected membership, both at Group Board level and within the Regions and Areas, my sense is that there is acute concern as to how such reform can be made compatible with the democratic control that needs to be exercised by members in a consumer co-operative. I, however, am confident that the two are fully compatible.

In defining what is meant by democratic control, however, certain striking misconceptions are apparent. In particular, the belief that the organisation has always been run at Group Board level by a majority of elected lay members is a myth. In fact, the present composition of the board, with a majority of lay members, is less than 15 years old. It dates from the 2000 merger between the Co-operative Wholesale Society and the Co-operative Retail Services. Prior to that, a majority of the members of the Group Board of CWS were corporate members bringing commercial experience and representing the independent societies that had originally established CWS.

Against this background the working approach of this Review has been to focus on the core tasks and activities that have to be undertaken by the Group Board and to identify the skills and experience required to fulfil them. At present, the composition of the Board includes 15 non-executive 'lay' directors elected by individual Regions, five non-executive corporate member directors elected from independent co-operative societies and, since December 2013, one so-called 'IPNED' i.e. independent professional non-executive director (the role to which I was appointed in December 2013).

In devising recommendations on the most suitable board composition for the Group, I have taken the firm view that to embed an ongoing distinction between independent, properly qualified and experienced directors (so called “IPNEDS”) and, on the other hand, so-called "lay directors” is unhelpful and divisive. Looking ahead, any solution that attempts to perpetuate such a distinction between IPNEDs and ‘lay directors’ - runs the inevitable risk of tokenism towards the latter group and the deliberate creation of second-class citizenship within the boardroom. That is an unacceptable outcome.

The Review is addressing this design challenge in two ways. The first component is to ensure that in future all appointments to the Group Board should be decided on the basis of objective criteria. These will be determined by the need to fill specific skill gaps on the Board that will equip it, in aggregate, to provide effective guidance and monitoring of executive management. Applicants for Group Board positions will, in addition, need to demonstrate strong commitment to co-operative values and principles. This will be an important dimension of the evaluation process and will be confirmed and underscored in their letters of appointment.

On the basis of this approach, democratic control on the Group Board will be maintained in two ways: first, all non-executive directors will themselves be members committed to co-operative values and principles; second, all such directors will be subject to annual election/re-election by the entire membership.

In parallel with this essential reform to the structure and composition of the Group Board, the second pillar of the governance framework that I shall be recommending is the establishment of a National Membership Council (NMC). This newly created body would, in summary, have two primary roles: first, to act as the guardian of the Group’s commitment to co-operative values and principles and to ensure that these are reflected in its corporate vision, strategy and operating practices; second, to act as a consultative body that would regularly engage with the Group Board and hold it to account. Further details of these proposals are set out in the 10 recommendations at the end of this update on the progress of my Review.

Ongoing effective dialogue between the Group Board and the NMC based on mutual trust and respect are the core of my proposed reforms. To help ensure that NMC members retain full confidence in the objectivity of the appointments process to the Group Board, I also propose that a Nominations Committee of the Board should be established on which two members of the NMC would serve.

The third essential component of my reforms is to strengthen the rights of ordinary members. “One member, one vote” has been a core principle of co-operative ownership, yet at present ordinary members do not have the right to attend Annual General Meetings or vote to elect or re-elect Group Board directors. I propose to reaffirm the importance of this principle in my recommendations. In my report, I will focus on the fact that The Co-operative Group does not function as a real democracy. Ordinary members have very little power and I recognise that, aside from the influence of corporate members from the independent societies, the future of my recommendations lies in the hands of around 100 elected individuals on the current Group and

Regional Boards, few of whom have any serious business experience and many of whom are drawing material financial benefits from their positions.

Further governance weaknesses

I am also drawn to the need in my report to address several other critical weaknesses in the present governance arrangements.

First, I am deeply troubled by the disdain and lack of respect for the Executive team that I have witnessed from some members of the Group Board. There is a phrase frequently used in Co-operative Group circles that the Executive should be "on tap but not on top". It is now clear to me that this is a widely held but deeply flawed representation of the reality in recent years. Elected directors have simply not been up to their task of holding the Executive to account.

A related issue is that elected directors often appear confused as to whether they are acting as delegates, mandated by their Regions and Areas, or representatives of the entire membership and obliged to act in the best interests of the Society as a whole. This problem is exacerbated by the structure of the present electoral system which requires Group Board directors to hold concurrent elected positions on Area Committees, and Regional Boards. As a result, Group Board directors face elections, as often as annually, at one tier or another of this complex electoral hierarchy. Failure to be re-elected at any lower tier level automatically requires resignation from higher level positions. Such an electoral system, while purportedly aimed at keeping elected members close to their constituents, in reality creates strong incentives for short-termism, the very reverse of the long-term perspective that the customer ownership model is expected to provide.

A second, quite fundamental concern is that this lack of effective governance exists in a situation where the Co-operative Group's core business is in food retailing, an economic sector with high competitive intensity. This now looks set to increase still further, with a resulting adverse impact on profitability for all major retailers. Without fundamental change in its governance, it is difficult to envisage a major strengthening of the Group's competitive position.

In this context, it is important to draw attention to one distinctive difference of mutually-owned organisations from other ownership models: the even greater need for a high-performing board. The reason for this is that, unlike investor-owned businesses which are subject to external scrutiny through a variety of independent governance mechanisms – investment analysts, fund managers and, ultimately, the threat of takeover – co-operative businesses are immune from these pressures. Regrettably, the Group Board has failed in this regard.

Indeed, it is clear to me that in recent years, the Group Board has spent far too much time on transactions such as Somerfield and Britannia that have been breathtakingly value-destructive. Not enough time has been devoted to the relentless ongoing task of improving, step by step, the performance of existing businesses and, for example, ensuring that the Group's IT platform is fit for purpose. It is critical agenda items such as these that should have been the focus of the Group Board's interaction with the Executive team. Correspondingly, this is where the inexperience and lack of qualifications of its lay directors has cost the Group dearly.

Against this background, I regret having to give only a partial account of the work that I have been able to undertake so far with my Review team. In order to develop a rounded picture of the Group's performance over time, I have studied in some depth the process of earlier reform initiatives, going back to the Gaitskell and Crosland Independent Commission in 1958 and the subsequent Blair/Monks Co-operative Commission report in 2001. What is striking about these earlier exercises is the degree to which their recommendations for reform, while compellingly argued, were nevertheless largely dismissed and ignored. This time, such an outcome will create significant risk of the demise of this organisation.

I am not yet in a position to lay out in full the depth of analysis that I intend to include in my Phase One report. Nevertheless, even at this interim stage, I would like to give an indication not only of the activities of the Review team since it began its work in January but also to provide an outline of the ground that I intend to cover in my Phase One report.

The scope of the Governance Review

Over the past three months, the Review team has engaged in an intensive effort to analyse the nature and causes of the Group's governance dysfunctions, explore potential solutions to remedy them and devise recommendations to ensure that the Group's governance is fit for its scale and complexity.

The activities of the Review team have included the following:

- Meetings with Group Board directors, executives and staff, individuals directing or managing co-operatives in the UK, professional advisers , interested stakeholders and academics specialising in co-operatives

- Reviewing a wide array of internal documents, including materials on past constitutional reviews to understand why previous efforts failed to achieve fundamental changes to a governance architecture long known for its labyrinthine complexity and its dysfunctionality

- Researching mutual forms of ownership in several sectors to understand better why certain ones have succeeded while others have failed. The Review team has also looked into the governance arrangements at other leading co-operative and mutual organisations in the UK and abroad

Outline of the Phase One report

The Phase One report, which I expect to publish by the end of April 2014, will correspondingly cover the following ground:

Chapter 1 will set out the context of the Review and discuss its scope and approach.

Chapter 2 will examine the current governance structure. It will analyse the structure, composition, and responsibilities of – and the election processes relating to – the Group Board, Regional Boards, and Area Committees. It will also look at the character of the Group's membership base and the rights accorded ordinary members, which are exceptionally weak for an organisation that proclaims its democratic credentials. Lastly, it will examine governance features that have contributed to the entrenchment of incumbents and weakening of democratic co-operative principles.

Chapter 3 will trace the history of the Group's governance system, particularly the failure of successive attempts to secure fundamental reform, even in the face of serious and sustained competitive pressures.

Chapter 4 will analyse the weaknesses of the Group's governance model, in particular a manifestly ineffective Group Board, intermediary structures that have exacerbated the governance system's dysfunction, and a disempowered and neglected membership.

This chapter will also explain why an effective board is particularly critical for co-operatives in the absence of other governance controls. It will show how current democratic processes have consistently produced a Group Board with acute and worsening failings. It will demonstrate the systemic nature of these governance deficiencies and argue that a complete redesign of the Group's democratic structure is urgently needed and incremental change will not suffice.

Chapter 5 will set out recommendations relating to the Group Board, intermediary structures and the membership. The major elements of these proposals are summarised below.

Key recommendations

The key recommendations of my Review are intended to provide the Group with a robust governance framework to replace the current flawed system.

It is also imperative that governance reform of The Co-operative Group should be fully in accord with its core values and principles. That objective is at the forefront of these proposals. In particular, the recommendations strengthen the provision of the "one member, one vote" principle and increase the rights of all members to voice their views. The proposals are also designed to address severe weaknesses in the current board structure that permit a facade of democratic control without delivering the reality of genuine strong governance.

They include:

- The creation of a new Group Board made up of an independent chair with no previous association or involvement with the Group, six to seven independent non-executive directors, and two executive directors. The non-executive directors would have the skills and experience of NEDs sitting on the boards of The Co-operative Group's primary competitors. This new, far smaller Board would replace the existing 20-strong elected Board; it would be responsible for all commercial and financial matters and would have full power and responsibility for the operation and management of the Society

- The establishment of a National Membership Council (NMC) of around 100 individuals, including provision for representation of around 20 employees. This new Council would have powers to ensure that the Group adheres to co-operative values and principles, and that these are reflected in its corporate vision, strategy and operating practices. The NMC would elect from its membership an Executive Committee of 12 which would also include corporate representation from independent societies

- Group Board directors would be subject to annual election/re-election by all members. Vacancies would be openly advertised and candidates would be appointed on merit against clear criteria of skills and experience. A Nominations Committee of the Group Board would be established on which two members of the NMC would serve. The Nominations Committee would also be responsible for commissioning an annual review of board effectiveness and reporting to the Annual General Meeting in light of this review

- The NMC would be encouraged to propose Co-operative Group members possessing the requisite competence to the Nominations Committee for consideration as Group Board candidates.

- Elections to the Group Board and the NMC would be conducted on the principle of "one member, one vote". NMC members would be elected by all members for a term of three years. Detailed voting arrangements, including the structure of regional/national constituencies and the method of voting would be the subject of analysis and consultation in Phase 2. Once the proposed arrangements were approved, the present membership architecture would be disbanded and transitional arrangements put in place. A revised remit and role would be developed for Area Committees.

- The NMC would have two primary roles: first, as guardian of the values and principles of the Group's constitution. The NMC would protect the Group's position as a member owned organisation. In this capacity it would hold certain powers to veto further changes in the revised constitution; nothing would be done to increase the vulnerability of the Group to takeover or demutualisation. The NMC would also hold the Group Board to account on ethical matters and oversee the Group's social goals programme

- The second primary role of the NMC would be to hold the Group Board to account for its stewardship and strategic leadership of the organisation and for the operational performance of the Group. In this capacity, the NMC or its Executive Committee would have the right to be consulted on key strategic and operational initiatives along with any aspects of the management of the Group. A "significant transaction" rule would be introduced, giving the entire membership a vote on large deals which can currently be approved by the Group Board alone

- To facilitate its work, the NMC and its Executive Committee would be supported by a secretariat. Arrangements would be put in place to safeguard confidentiality of information shared by the Group Board and Executive with NMC members.
- Independent societies would cease to sit on the Group Board and a new enhanced structure would be established to promote trade and protect interests in common between the Group and these independent societies. The independent societies have a high and necessary dependence on a viable, efficient and competitive Co-operative Group. Their own future economic success is also highly reliant on the effective working of the current joint trading relationships. The Co-operative Group should however now review all matters resulting from this complex historic trading relationship with the independent societies.
- All rule changes would contain a so-called "sunset clause", under which the constitution of The Co-operative Group would return to the current status quo after a period of four to five years without a member vote to retain the new structure

Next steps

The proposals outlined above will be finalised over the next several weeks and set out in detail in the forthcoming Phase One report. This will also include recommendations on transitional arrangements. The report will be put forward at the 2014 AGM. It will also, of course, be available to the millions of ordinary members of the Group via the Myners Review website.

Work on Phase Two of this Review will only begin once decisions in principle on support for my recommendations have been made by the membership. Contingent upon that outcome, my goal is to develop a Phase Two report that addresses outstanding aspects of the governance architecture and facilitates appropriate consultation ahead of specific Rule changes to be proposed at a Special General Meeting later this year.

As I have stated before, I have no power to decide the implementation of my Review proposals. The required Rules changes will be decided, under The Co-operative Group's constitution, via the block votes of the Regional Boards together with the independent societies. Under these arrangements, a minimum two-thirds majority is required to pass Rules changes. The future of my Phase One recommendations will therefore potentially lie in the hands of fewer than 50 elected members who, acting in concert, would be able to cast more than one-third of the Society's votes against these proposed reforms. Until the outcome of these constitutional changes is decided, it is my opinion that it would be inappropriate and premature to proceed with the appointment of a new CEO, in view of the risk that, while these governance issues remain unresolved, The Co-operative Group will be unable to attract applications from best-in-class retail executives. Confirmation of members' readiness to approve radical governance reform will also be essential to reduce current uncertainty among existing key employees.

For all these reasons, I commend this interim account of my proposals to the entire membership for their serious consideration.