

Paul Myners Esq
Myners Review
Room 4/16
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

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Dear Paul

**INDEPENDENT REVIEW OF THE CORPORATE GOVERNANCE OF
MUTUAL LIFE OFFICES: CONSULTATION DOCUMENT**

Thank you for your letter of 9 July. We at CIS are fully supportive of any initiative to promote and enhance best practice in corporate governance in the life sector and we very much welcome the opportunity to respond to your Consultation.

Responses to the specific questions are set out in the attached schedule. The main points we would make are:

- We believe that a large part of the governance framework applicable to listed companies can apply equally to life mutuals
- CIS seeks to apply best practice as formulated in the Combined Code subject to modifications necessary to take account of CIS' singular status
- The co-operative model of trading is particularly conducive to strong corporate governance in that it involves democratic participation by customers
- The responsibility for ensuring that life companies have adequate corporate governance procedures is already implicit in the FSA's current remit

Continued/....

We should point out that CIS is not a conventional mutual life office in that it possesses a share capital and is owned by another Industrial and Provident Society rather than by its policyholders. However, it has always transacted its life business solely for the benefit of its policyholders and its shareholder has never participated in the profits of the life business. It therefore shares many of the characteristics of a mutual life office. At the same time it transacts general insurance business with a view to making profits which may be distributed to its shareholder by way of dividend.

CIS is wholly owned by Co-operative Financial Services Ltd ("CFS") which is in turn owned by the Co-operative Group (CWS) Ltd ("the Group"). All three companies are Industrial & Provident Societies.

The Group is both a primary consumer co-operative and a secondary co-operative society and is owned by both its consumer members and other co-operative societies. Membership of the Group is open to any regular customer of its businesses (including CIS) over the age of 16, subject to investing at least £1 in the society, and members are entitled to vote. Through this structure, CIS policyholders can obtain voting rights in our ultimate parent (although they do not have direct voting rights in CIS).

Our attached responses have also been approved by CIS' Chair and Secretary.

We look forward to receiving your findings in due course. In the meantime, please do not hesitate to contact me if you have any further questions.

Yours sincerely

Mervyn Pedelty
Chief Executive

CIS response to the Myners review of the governance of life mutuals

Q1. To what extent does the current guidance on corporate governance particularly the Combined Code provide an appropriate framework for mutual life offices? Would another approach be more effective?

CIS' policy, as stated in its annual report, is to comply with the Combined Code in so far as practical and applicable to an Industrial & Provident Society. In addition, CIS observes the Corporate Governance Code of Best Practice (CoBP) issued by Co-operatives UK which sets out best governance practice within the wider co-operative sector.

This reflects our view that the broad framework which has been devised for listed companies can be applied more widely, and we believe it would be appropriate for other mutual organisations to adopt a similar approach including adherence to the "Comply or Explain" principle.

In its annual accounts, CIS sets out details of its system of internal controls and the processes used by the Board to ensure their effectiveness. The independent auditor reviews whether this statement reflects compliance with the requirements in the CoBP and reports if it does not.

A copy of the latest Report and Accounts is enclosed.

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

In practice, any material shortcomings in a mutual life office's corporate governance are likely to represent a breach of the FSA's Principles for Businesses. The existing powers of the FSA should therefore be sufficient to secure practical compliance with many aspects of corporate governance best practice. In order to secure enhanced compliance the FSA could be granted explicit powers to ensure that all insurers achieve an appropriate level of compliance with best governance practices.

Q3. In your opinion, should the ownership structure or the nature of the business conducted by a life mutual affect the composition or structure of its board? If so, how?

We believe it is important that the ownership structure and the nature of the business conducted by insurance companies are reflected in the structure and composition of the board.

In the case of CIS, the board consists of the following groups

- executives drawn from CIS and CFS, who have been involved at a senior level within the financial sector for some years
- non-executives drawn from the executive of the Co-operative Group
- non-executives who also serve on the board of the Co-operative Group and who are either employed by its corporate members or are representative of the individual membership of the Group (the latter are considered to be “independent” for the purposes of the CoBP)
- professional independent non-executives who have extensive industry experience, including significant expertise in life and general insurance.

We believe that this structure provides an appropriate balance and breadth of experience of specialists and generalists, executives and non-executives and independent and non-independent directors. It also reflects the co-operative nature of our ownership and, ultimately, allows the exercise of individual members’ rights through democratic principles. We have described it here in the belief that it may be of interest to others in the mutual sector.

Q4. In your experience, is the information and advice (including actuarial advice) used by the non-executive directors of life mutuals sufficient – in terms of quality and relevance – to enable them to exercise effective oversight of the executive? In what ways might it be improved? If more information and advice is needed, what are the resource implications? Do similar issues arise for the non-executives of other complex businesses, such as wholesale banking or science-based businesses?

Because of the complexity of life insurance business, particularly with-profits life business, the provision of high quality, relevant information and advice represents a challenge for all life companies, not just mutuals. It is widely accepted that the basis for presenting financial information which life companies have been required to adopt for the published accounts and regulatory returns has in the past not given an adequate indication of the financial strength and performance of a life insurance business. The new “realistic” reporting requirement which the FSA are introducing for with-profits business will go a long way to providing a more accurate measure of the financial position of a life company.

One of the factors that distinguishes the position of mutual life businesses is that there is not a single overall measure of financial performance such as is available to proprietary operations in the form of “profit” or “return on capital”. It is therefore particularly important to provide information to the board of a mutual which gives an indication of the individual elements of performance, namely cost efficiency, distribution effectiveness and investment performance, as well as of risk management and the likely costs of policyholder expectations.

Existing and potential CIS non-executive directors are provided with training sessions to assist them in interpreting the financial information which is presented to them. Directors seek independent external advice on particularly complex matters, and advisers may attend board meetings to provide expert input on complex issues.

We are supportive of the FSA’s impending changes to the role of actuaries within life insurers and the introduction of peer reviews. The CIS board has retained an external actuarial consulting firm to advise on CIS’ compliance with its principles and practices of financial management (PPFM) and we believe that this process will also help to further enhance directors’ understanding of this important but complex area.

Q5. What is the role of the non-executive director in a complex or technical business? In particular what is their capacity to understand and to challenge the executive over technical aspects of the business?

It is essential that the board of a complex or technical business includes non-executive directors with sufficient depth of knowledge and experience to challenge the executive on technical aspects, and that there are other non-executives with a wide experience of and interest in financial affairs. However, it is not possible for all non-executives to be equally knowledgeable or for all directors to bring the same perspective to issues.

As explained above, the board of CIS includes non-executive directors of both the above types. We find that the inclusion of a sufficient number of directors with significant relevant experience ensures that the process of questioning and challenging of executives is carried out effectively. Many of the important issues affecting CIS are also considered at meetings of the CFS board (and in certain cases of the Co-operative Group board), thus ensuring that the owners of CIS can more generally appreciate the matters being considered by the CIS board.

- Q6. What can the owners of a complex or technical business reasonably expect of its non-executive directors? How would you characterise the practical limitations of a non-executive director? What steps might be taken to codify what is reasonable and realistic in this context? Should executives and non-executives have the same legal duties to the company?**

The question rightly recognises that many firms, for example those involved in the energy industry and those with extensive exposure to commodities or currencies, also have to deal with complex technical issues. In this sense the life insurance industry (whether mutual or proprietary) is not a special case. The reasonable and realistic expectations required of non-executive directors have been extensively discussed in the period leading up to the implementation of the current version of the Combined Code, and we do not take issue with the views which emerged. The current state of the law where directors (be they executive or non-executive) are required to bring their actual expertise and knowledge to the benefit of a company is in our view right, but over and above this we can see no reason for any difference in the formal legal duties to the company required of executive and non-executive directors, which we believe could be divisive and therefore ultimately work against good corporate governance.

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

CIS policyholders have the right to become members of the Co-operative Group and participate in its affairs on a one-member one-vote basis. In particular, members are able to take an active part in its regional organisation and ultimately to stand for election to its board. The Group holds twice yearly meetings at both national and local level covering the affairs of all its businesses including insurance. This enables direct consultation with the membership, and provides a mechanism for members to question the direction being taken by the businesses. Through these and other means (including the presence of individual Co-operative Group members on the CIS board) we encourage members to engage actively and with a democratic mandate.

We believe the co-operative model largely eliminates the risk faced by mutual life companies that, if policyholders have the right to introduce and vote on resolutions for management action, one group of policyholders can force the company to act to benefit that group at the expense of other policyholders or stakeholders.

We are in the process of asking CIS policyholders to endorse our Socially Responsible Investment policies and to inform our thinking by letting us know their priorities in Social, Ethical, Environmental and

Corporate Governance issues. The Co-operative Bank is, of course, already well known for its ground-breaking initiatives to involve its customers in formulating its policy on ethical issues.

CIS believes that consumer education is a very important area for development in financial services and better educated consumers will help to stimulate engagement by policyholders. We are very supportive of the introduction of the PPFM, which provides a mechanism for policyholders to obtain a better appreciation of the operation of with-profits funds. This initiative will, however, have its biggest impact when “customer friendly” versions of the PPFM are produced next year.

Q8. Lord Penrose says that in a life mutual “...it is the policyholders who are the source of the risk capital for the enterprise.” (chapter 20, paragraph 51). What does this mean for the relationship between a mutual life office and its policyholders?

The principal distinction in this regard is not so much between a mutual and a non-mutual as between offices which write with-profits business and those which do not. With-profit policyholders typically bear the risks and rewards of most or all of the business of the long-term fund. This applies to both proprietary companies, where with-profits policyholders typically provide 90% of the risk capital, and mutuals where policyholders provide the whole of the risk capital, although in both cases much of this capital will have effectively been provided by previous generations of policyholders.

We believe that it is important for policyholders to be given the opportunity to understand and appreciate the above principle and the fact that mutual companies have little choice but to use with-profits fund capital to support new projects. As mentioned above, we have been supportive of the publication of PPFMs, which will assist in addressing this issue and in ensuring accountability to policyholders as providers of capital.

Q9. Lord Penrose acknowledges that the FSA’s work since 1997 “...has sought to anticipate many of the lessons that might be drawn by this inquiry, and it should come as no surprise that it has largely succeeded in that.” (chapter 20, paragraph 3). In so far as corporate governance is concerned, do you agree?

Yes.

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

As stated in our response to Q2, we are of the view that a mutual life company which had serious deficiencies in its governance arrangements would almost certainly be failing to comply with the FSA's Principles for Businesses. It seems reasonable for the FSA to be given specific powers to ensure that a high standard of governance is maintained throughout the industry.

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

In the case of CIS, both CFS and the Co-operative Group now play a major role in overseeing the performance of CIS and its management.

As far as mutuals more generally are concerned, there is an increasing focus throughout the industry on financial strength and capital resources as well as on the more traditional areas of investment performance and value for money. Rating agencies and other expert analysts are now including mutual offices within their coverage, thus allowing the press to comment on the performance of mutuals more widely than in the past. The FSA's approach to insurers' capital adequacy will in the future explicitly take account of such a market role in promoting financial security.

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

Both mutuals and co-operatives are affected by the fact that they have more limited access to fresh capital, particularly equity capital.

The FSA's consultation paper CP207 contained significant restrictions on the use of capital by insurance companies which would have seriously impacted the development of mutual life insurers, including CIS. We are pleased to see in the follow-up document CP04/14 that the FSA have confirmed that mutuals will be able to continue to use existing capital to finance appropriate business ventures.

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

The primary drivers of demutualisations have been, on the one hand, the prospect of a windfall for the current generation of policyholders and, on the other, the perception of some boards that their organisations needed to raise capital or expand distribution.

The framework of the co-operative movement, including its democratic structure and strong values and principles, effectively prevents the demutualisation of CIS.

Q14. What specific governance arrangements currently apply to other financial mutuals? In what ways do their governance arrangements differ from those that apply to life mutuals? Which, if any, of the options for life mutuals could be applied more widely in the financial mutual sector? What would the consequences be?

We have no comments to make on this question.

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

The real cost of good governance as now accepted must inevitably mean that small mutual life firms will carry a significant (and perhaps disproportionate) overhead.

Q16. Are you aware of effective governance regimes for life (or other) mutuals in other countries? Is this the result of a formal (regulatory or government) requirement or is it voluntary, driven by the industry? Are there aspects of the arrangements in other countries that it would be desirable and practical to adopt in the UK?

We have no comments to make on this question.