

**David Strachan, Sector Leader
Insurance**

Direct line: 020 7066 0900
Local fax: 020 7066 9769
Email: david.strachan@fsa.gov.uk

Myners Review
Room 4/16
HM Treasury
1 Horse Guards Road
LONDON
SW1A 2HQ

16 September 2004

Dear Sirs

REVIEW OF THE CORPORATE GOVERNANCE IN LIFE MUTUALS

1. The FSA welcomes the opportunity to provide its views on the questions posed in the consultation document and I set out below our thoughts in the order raised in the consultation document. Our response focuses on our interest in our capacity as financial services regulator in the UK.
2. One of our roles as regulator is specifically about securing the appropriate degree of protection for policyholders as customers of the firm. It is important to understand that the Financial Services and Markets Act 2000 (FSMA) does not give us a direct role in protecting policyholders as owners of firms. Our response reflects the extent of our responsibilities, and it is therefore narrower than the scope of the Review.
3. We believe that strong and effective corporate governance in the firms we regulate is central to the continuation of efficient, clean and orderly financial markets. Although there are some different issues that apply to mutuals, governance has similar principles in all types of firms.

Background

4. We set out below some detailed comments in response to the specific questions you have raised. However, we thought it would be useful to set out some background to put our views into context.

The scope of regulation and the mutual insurance sector

5. FSMA gives the FSA powers to regulate firms operating in various parts of the financial services sector, including banks, building societies, credit unions, insurance

companies, friendly societies, securities and investment management firms. As at 31 March 2004 there were 10,712 authorised firms. Our remit will shortly be extended further with the inclusion of mortgage and general insurance intermediaries (adding approximately another 20,000 firms to our portfolio).

6. Of the firms we currently regulate, as at March 2004, about 770 were insurance firms of which 204 were engaged in life insurance.
7. Historically, mutual insurance societies (which took a variety of forms) accounted for a very significant proportion of the total life business, and particularly with-profits business, carried on in the United Kingdom. However, the last ten years or so have seen a major restructuring of the sector, including in the demutualisation and flotation or sale of some important players in the market. Even since we took on responsibility for insurance regulation in January 1999, firms such as Scottish Widows, Scottish Provident, Scottish Life, Friends Provident and National Mutual have demutualised. They were preceded by others, including Norwich Union, NPI, Scottish Equitable, Clerical Medical and Scottish Mutual. Of the companies that remain, of course, Equitable Life was unsuccessful in its attempt to demutualise in 2000, while Standard Life has this year announced its intention to demutualise.
8. The new “realistic reporting” arrangements that we are introducing will apply to the 37 largest with-profits life insurance firms that we supervise, which between them operate 46 with-profits funds. In terms of total savings, they account for 98% of the with-profits business in the UK. Only nine of those firms are mutuals, including three friendly societies.
9. There are some smaller mutual insurance companies. However, most of the other mutual life and general insurers are either registered or incorporated friendly societies, of which there are 211.
10. We recognise that the remit of the Review is specifically to look at the issues surrounding the governance of mutual life insurers. However, as the review team will be aware, part of the purpose of bringing regulation of financial services within the remit of a single regulator was to bring consistency to the approach to regulation of different types of firm. A key part of our approach has been to develop a risk-based framework to meet our statutory objectives, taking into account the principles of good regulation, to prioritise our efforts and focus on the most significant risks. It is important to note that underlying this prioritisation we recognise that, given the risks in financial markets and the desirability of avoiding moral hazard, a zero failure regime is neither achievable nor desirable. Mutuality has not, of itself, been a major factor in determining our approach to regulation, though we do of course take it into account where relevant.

FSA regulation and powers

11. In terms of our role and approach, it is important to understand that there are a number of different aspects to what we do. The current environment and the powers

we have are very different from the regime that existed under the Insurance Companies Act 1982 and during the period studied by Lord Penrose in his inquiry of the Equitable Life Assurance Society.

12. First of all, we have a gatekeeper role. Subject to a small number of exemptions, firms are only allowed to carry on regulated activities, of which life insurance is one kind, in the UK if they are authorised by us (or a regulator in another member state in the European Economic Area). We carefully vet firms to ensure that they meet the threshold conditions laid down in FSMA. We also have a role in approving certain employees of authorised firms, such as senior management. Authorisations and approvals can be withdrawn if the firm or individuals concerned fail to meet the necessary standards.
13. Second, we set rules with which authorised firms must comply. These include high level standards requiring all firms and approved persons to meet their fundamental obligations of all firms under the regulatory system. This includes the responsibilities of directors and senior management and the minimum standards for becoming and remaining authorised or approved. We set more detailed requirements relating to firms' day-to-day businesses, specifying the levels of capital they must hold and the way they must behave when selling certain types of products to the public. Detailed rules are often supplemented by guidance. If a firm breaches our rules, it is open to us to bring disciplinary action, which can result in us making public statements about the firm and/or imposing a penalty. We also have disciplinary powers in relation to approved individuals.
14. Through our risk-based framework for supervising firms, we seek to satisfy ourselves that firms are complying with the threshold conditions and our rules. But we also use this process to assess risks on the firms concerned and to establish a mitigation programme that the firm must follow to deal with those risks. The controls and other governance issues are an important part of that assessment.
15. We aim to be consistent in our approach to supervision across the sectors with the risk to our objectives being the main factor determining the way we use our resources and the action we take.
16. Pursuant to our powers in part XXI of FSMA, the Treasury have transferred to us certain functions under the legislation relating to friendly societies, building societies and industrial and provident societies (including credit unions). Those functions relate mainly to maintaining the public record of such societies and, broadly, they correspond to the functions carried out by Companies House for companies (for which we have no corresponding functions). We have no role in setting the requirements for the corporate code for these societies since those requirements are set out in primary and secondary legislation.

Detail

Question 1 (corporate governance guidance) - 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?

17. The Combined Code on Corporate Governance (the "Combined Code") was designed with large listed companies in mind. However, the most recent version of the Combined Code also caters for smaller listed companies, imposing lesser requirements on non-executive directors. Even relevant firms do not have to comply with the Combined Code in every respect, provided they explain to shareholders why certain provisions of the Combined Code are inappropriate for their circumstances. While other firms are not under any obligation to comply with the Combined Code, many firms, including a number of the larger mutual life insurers, have chosen to comply as a matter of policy, at least to the extent that its terms are relevant to them and are not in conflict with their constitutions. Several of those firms, including the large mutual life insurance companies, already include a statement in their annual report and accounts about the extent of their compliance with the Combined Code.
18. We regard good corporate governance as important for all the firms we regulate and this is clear in the structure of our Handbook of rules and guidance. That premise holds as true for smaller firms as it does for the larger firms. In managing its affairs, we state that a firm should have regard to generally accepted principles of good corporate governance including the Combined Code where appropriate. In addition, the Combined Code underlines the importance of internal controls, and stresses the need for the board to maintain robust internal controls, and review the effectiveness of all aspects of its business, including financial, operational, compliance controls and risk management (The Turnbull Guidance on internal controls is now in the process of being updated by a group led by Douglas Flint of HSBC).
19. So far, we have found our regulatory approach, which relies on general principles and supervisory follow-up rather than detailed rules, appropriate to our needs. In particular, we would be concerned about the problems that might arise if we tried to insist that all the firms we regulate should comply with the Combined Code (currently the requirement is for listed firms to comply with the code or explain otherwise). We think that because the firms we regulate may take any number of legal forms (companies of different kinds, friendly societies, building societies, industrial and provident societies, partnerships, incorporated and unincorporated associations or even sole traders) it would be difficult to have an omnibus code that could be applied to all types of firms. We also doubt that it would be proportionate to impose such requirements in respect of some kinds of firm: we are required by FSMA to undertake and publish a cost benefit analysis of any rules we make that are binding on authorised firms.

20. We would be equally concerned about introducing new rules that would discriminate, without good reason, between sectors. It would seem to us to be particularly inconsistent if we were to impose specific, rigid governance requirements on authorised mutual insurance companies when we have no such requirements for any of the other form of regulated entity. With listed firms the only other group subject to such restrictions, this would leave a significant inconsistency in approach.
21. While we keep these issues under regular review, we have so far concluded that our current mix of regulatory rules and our supervision process has enabled us adequately to tackle governance issues. We are, however, carrying out further work to ensure a more consistent approach to our assessment of the governance across all firms. We will of course reconsider this position in the light of any concerns that your Review identifies.

Question 2 (corporate governance guidance) - What is the best way of securing life offices' compliance with corporate governance best practice?

22. As noted in our response to question one, from a regulatory perspective, effective governance is something that we consider can best be assessed and secured through our risk assessment process, supplemented by our high level rules. These rules include that firms should have, for example, adequate systems and controls (including financial, operational and compliance controls and risk management), complaints procedures and anti-money laundering controls.
23. Because of the importance we attach to this aspect of our work, we have recently undertaken a review of governance issues, with particular focus on the insurance sector. Our objective is to better equip insurance supervisors to investigate and challenge the governance arrangements at insurance firms, and we will continue to work hard to achieve this. We are carrying out similar initiatives in other sectors.
24. Given that there are a relatively small number of mutual insurers, which take a number of different forms, as described above, we think it is likely to be difficult for us to use our powers in this area to introduce rules that would be able to reflect the structure of each kind of mutual. As noted above, we are also concerned about consistency between sectors and the cost-benefit analysis.

Question 3 (board effectiveness) - 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?

25. We consider that the structure and composition of the board of an insurance firm should take account of all these factors, irrespective of their type. The key points are for a board to be composed of suitably skilled and experienced individuals who collectively have sufficient knowledge of all the firm's markets and products and the risks associated with the firm. The structure and composition of the board clearly have to reflect the complexity and degree of risk inherent in the business. Our high level standards explain in further detail the responsibility of regulated firms to take

reasonable care to establish and maintain such systems and controls as are appropriate to its business. Although we would expect a majority of the board of an insurer to have experience in the financial services industry (with some but not necessarily all of that expertise in insurance), we also consider that there may be benefits in having non-executive directors (NEDs) who have experience of other businesses and disciplines, but also personal qualities, skills and experience that will enable suitable challenge to be provided to executive directors. For example, on the board of a financial services firm we would expect to see knowledge in a range of technical areas, including actuarial and accountancy skills. The need for such expertise will clearly be driven by the nature of the business of the firm and, realistically, the size of the firm concerned.

26. Another important issue is the level of training that is given to NEDs, particularly when they join the board. We would expect an ongoing training programme to be in place for all NEDs to ensure they have adequate knowledge of the current issues in the industry to make informed decisions and provide sufficient independent challenge to the board and executive. The issues raised here are covered to some extent in the Prudential Sourcebook. Examples of issues that NEDs should be trained on are the new capital requirements being introduced by the FSA and for composite firms the introduction of general insurance regulation. In addition, it is important for executive directors newly appointed to the board also to be trained, as there may be instances where it is too often assumed that they are already aware and understand their new legal and governance responsibilities.
27. Clearly the practicality of having such training will depend on the nature and size of the firm, and we would expect the amount of training to be proportionate to the size of the firm and the nature of the risks associated with the business.

Question 4 (board effectiveness) - 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?

28. Within our supervision work we have seen management information of varying quality, particularly on the level of appropriate detail and focus, and we will continue to require firms to make improvements where necessary. Access to management information is clearly an important issue and one of the things that we aim to look at as part of our risk assessment of firms. Directors of firms will be better placed to express a view about the information they personally receive in terms of its coverage, relevance, quality and comprehensibility.
29. However, there are some general observations we can make about effective management information, which apply to all types of firms. From a regulatory perspective, firms' arrangements should be to furnish its governing body with the

information it needs to play its part in identifying, measuring, managing risks of regulatory concern. The information provided to the board should be adequate, timely and focused to ensure the main issues are apparent to the NEDs. In addition, NEDs should have access to independent advice and have a mechanism within the firm whereby advice can be sought internally when needed. For example, actuarial information in life insurers is often very complex and it is important to ensure that sufficient explanation of the information is provided and advice available if non-experts on the board are to be able to understand the significance of the information provided to them. If any of the information provided to the board is not concise and easily understandable, it is the responsibility of the directors to request a better explanation and, longer term, to require changes to the management information pack to prevent this problem persisting with a consequential risk to consumers, and potentially market confidence. The importance and role of management information in firms is highlighted in our Prudential Sourcebook.

Question 5 (board effectiveness) - 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?

30. A firm's governing body should include independent NEDs, with suitable personal qualities, sufficient knowledge and expertise to act as an appropriate challenge to the executive directors. It is critical for all members of a board to understand the business and the environment it is operating in. This does not necessarily require extensive technical expertise, but without a certain understanding of the issues or at least a capacity and willingness to enhance knowledge, effective challenge would not be possible.
31. It would not be appropriate to rely entirely on the advice of the executive directors or on external consultants when taking important decisions and this could result in the firm being controlled by a dominant individual, or group of individuals. The responsibility to maintain sufficient technical expertise in all areas on the board is normally that of the Chairman (and the members of a company or society). The aspects discussed here are covered in the FSA's rules, in both the Systems and Controls and Prudential Sourcebooks.

Question 6 (board effectiveness) - 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?

32. Whilst they are both critical to the effective running of the business, executive and NEDs have different roles to perform. As we have already mentioned, NEDs should provide suitable challenge to the executive directors and add value through their knowledge and experience. The distinction is in part driven by practicalities, since NEDs usually only work on a part-time basis and so the time available to them is

limited. However, executive directors and NEDs share responsibility for the performance of the business.

33. Our high-level standards are clear in defining our expectations of NEDs, in that we appreciate the role undertaken by a NED will vary from one firm to another. Provided that the NED, in his or her role has personally taken due care, a NED would not be held disciplinarily liable either for the failings of the firm or for those of individuals within the firm.
34. It is important that NEDs challenge what the management of the firm has been doing but also focus on the strategy of the firm, the way it will act in the future and, in many cases, this is the way they can have a greater impact and provide the greatest benefit to stakeholders. We would expect firms to evaluate on a regular basis their board and appraise its performance, making any appropriate changes to ensure that the board consists of the right skills mix appropriate to the scale, nature and complexity of the business, and the skills and experience of NEDs complement those of the executive directors. As with many of the points we have made, these comments apply equally to proprietary and mutual companies.

Question 7 (policyholder voice) - 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?

35. We recognise that individual policyholders often do not have a loud voice when it comes to influencing the running of a mutual. This is often not the fault of the firm or its management. Many policyholders probably do not feel that they have sufficient knowledge to get more involved or to be greater contributors. It also seems clear that consumers do not always appreciate that a significant part of the deal, when they invest in mutuals and receive membership rights, is that they are taking on a degree of responsibility for the firm and putting their capital at risk. This is not an issue that is unique to insurance mutuals.
36. In our experience, the amount and quality of information that firms provide to policyholders differs between insurance firms and among mutuals in particular. Some are very good at keeping policyholders up to date, others are less good. Whether or not the firm is a mutual does not seem to be a major factor in determining how good firms are in that respect. Of course, communications with consumers involve a cost, which ultimately has to be passed on to policyholders. Nonetheless, such firms are required as a minimum to provide a certain level of information, whether about the performance of their policy (an FSA requirement) or in terms of the report and accounts of the society.
37. A number of mutuals have, however, introduced arrangements to give policyholders a greater voice. Examples include cases where members have representation on the board or policyholder committees that report to the board on a regular basis. We consider these as positive steps and certainly welcome such arrangements where they

can be made to work in particular mutual (and indeed proprietary) firms. In practice, this is relatively easier in smaller firms and those where the customers are based on affinity groups.

38. However, it is not always easy for firms to put suitable arrangements in place. One difficulty is how the representatives are selected. There is a risk that policyholders who volunteer their involvement do not in practice represent the views of all such that one group of policyholders ends up with a disproportionate influence compared to other groups. This is significant because, as the consultation document recognises, there can be significant conflicts of interest between different policyholder groups. It should be noted that there are instances in a mutual firm where policyholder representation is required by our rules or otherwise, e.g. on a proposed demutualization.

Question 8 (policyholder voice) - 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?

39. As mentioned in the answer to question seven it is clear that policyholders have not always fully appreciated the risks they are placing on their capital by investing in a mutual firm. This is a particularly pertinent issue as, with the poor performance of equities in recent years, mutuals along with other firms have seen the capital in their estates reduced significantly. In poor economic conditions, proprietary firms can in principle ask shareholders to provide additional funds to back the business. In mutuals, the main way the capital strength of the firm can be restored is by reducing the benefits to the policyholders. We think that mutuals need to ensure they explain to policyholders the risks to their capital and how the firm is controlling them.
40. The ability of mutual firms to raise capital is a major issue. One of the reasons we have seen mutuals looking to demutualise or close to new business is that they have come under strain to the point where they feel the interests of current (and future) members can no longer be served by the firm continuing to market new products. There has been little evidence so far of mutuals being able or willing to borrow or use innovative capital instruments to meet their needs.

Question 9 (regulation) - 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 30 paragraph 3). In so far as corporate governance is concerned do you agree?

41. As we have already indicated, we have improved the way we monitor corporate governance in firms, taking a much more pro-active stance than in the past. A number of measures have been introduced for insurance firms, for example, some of which stem from our with-profits review, which has introduced various new requirements such as the with-profits committees and the need for a with-profits actuary and a separate actuarial function. We also introduced earlier this year the

requirement for with-profits offices to produce a document detailing their Principles and Practices of Financial Management. Firms will also need to produce a consumer friendly version of this, which we propose to be made available from mid 2005. The results of these requirements should improve the governance of with-profits business and a reduced risk of with-profits policyholders being unfairly treated. New arrangements for the preparation, actuarial review and audit of accounts are also relevant.

42. We think that corporate governance in mutuals is moving to a modern framework, but in some cases quite slowly. This may in part reflect the historical attitudes and traditions of some of the firms, and the difficulty in engaging the membership to bring about change. We think that, at this stage, working with firms to show the benefits of good governance is more likely to succeed than the imposition of new rules. This is why, as we have indicated above, we have made governance an important part of the risk assessment framework that we use to assess the risks that firms pose to our objectives.
43. Ultimately, while we cannot force firms to change their constitutions, if we see the corporate governance arrangements of a firm as a risk, we can require that the firm focus on mitigating that risk. We can also take action to vary or withdraw a firm's permissions to transact regulated business. That is a decision we would not take lightly, but is nonetheless one we would have to consider seriously if we thought the structure of a firm was so inadequate that it posed a serious risk to the threshold conditions and ultimately consumers.

Question 10 (regulation) - Is there a further role for the FSA to play in improving firms' corporate governance?

44. It is our view that the approach so far has been successful in significantly improving corporate governance in the firms we supervise. We will continue to take this proactive approach to ensure firms maintain a structure that is appropriate to their business and does not pose unnecessary risks to policyholders. We would reiterate, however, that we continue to work to ensure greater consistency in our approach to this area. We are open to and welcome new ideas on how to tackle corporate governance more effectively.

Question 11 (market disciplines) 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?

45. While the threat of takeover and the influence of major shareholders provide a market discipline on the management of listed firms, and these are not issues for mutual societies, we think there is nonetheless a range of market disciplines that can be effective in promoting good performance within mutuals.
46. Some mutuals have set up policyholder groups in order to feed the views of policyholders into the governance process. For example, one friendly society which

has locally elected member representation has found the challenge provided by its policyholder group effective. In this case, the members of the policyholder group tended to be very knowledgeable and well informed and, thus able to present an effective challenge to management. Other firms may not have the same kind of membership base.

47. Management may be motivated to seek the views of members (both positive and negative) as this can provide a means of identifying marketing opportunities and reducing lapse rates, which may allow the firm to make better use of its finite capital and human resources. At the very least, management should have some incentive to deliver competitive products and a degree of cost efficiency. For some firms, in particular those that operate primarily through a direct sales force, customers may have little or no comparative information and therefore they may find it hard to judge whether they are getting a fair deal or otherwise. In such firms, there is the danger that management could take advantage of the asymmetry of information to operate inefficiently. The FSA has a role to play there. Comparative tables detailing the performance of life insurers published by the FSA and the financial press go some way to help address this problem. Our disclosure requirements are also relevant. These sources of market information may not be readily accessible to consumers, but they are available to advisers and mainstream journalists who have more direct access to consumers.
48. Other market forces on mutual life insurers include consumer champions such as the Consumer Association. In addition, if a firm places substantial reliance on particular intermediaries as a source of business, such intermediaries may act as a powerful influence on the firm as a result of their role in advising customers on the suitability of particular products.

Question 12 (potential advantages of financial mutuals) Do specific barriers exist to the success of mutual businesses in the UK? If so, how might they be addressed?

49. We are not aware of any specific regulatory barriers that exist in the UK and which affect the success of mutual businesses.

Question 13 (potential advantages of financial mutuals). What are the forces that drive demutualisation? What are the implications of demutualization for members and customers?

50. From our experience, the principal driver of a number of recent demutualisations has been the enhanced ability to raise new capital and the greater flexibility that demutualisation is perceived to bring to the management of the firm.
51. In certain cases mutuals have demutualised because they were under financial stress and needed new capital in order to survive or remain open to new business. In other cases, demutualisation has been triggered by a desire for increased flexibility, for example where firms wished to develop into new markets, make acquisitions or increase investment freedom. Again, increased financial strength and the greater flexibility that this brings were the main driving forces.

52. In some cases mutuals that were previously stand-alone entities have become part of a larger financial group following demutualisation. In such cases, membership of a larger group may bring new distribution opportunities and therefore increased sales as well as enhanced access to capital and at the same time reduce overhead costs. Certain demutualisations have taken place as part of a group restructuring and have been used to de-risk the long-term fund, for example by transferring the ownership of a general insurance firm from the mutual to another part of the group, therefore relieving the life policyholders of the risk associated with the general business.
53. Another factor that has been cited in some cases is that while the firm concerned had historically been centred around its membership, namely the with-profits policyholders, as with-profits business has declined in favour of unit-linked products, the rationale for mutuality was being undermined, with ownership of the firm effectively being transferred to a minority group of policyholders. Demutualisation was seen as a way of realising value for all remaining qualifying policyholders at the time.
54. As regards implications for policyholders, the strengthening of an otherwise weak fund following demutualisation should be consistent with their interests as a stronger fund has more investment flexibility and is likely to be able to pay larger bonuses over time than a weak fund. As part of the process, where the mutual has a substantial estate, the demutualisation scheme has to ensure that policyholders (including different groups and generations thereof) are treated fairly.
55. In many cases, policyholders have received windfall payouts following demutualisation in exchange for their loss of voting rights in the firm, and in some cases for giving up interests in future distributions from the estate. In some cases policyholders have also been offered shares in the demutualised entity and have therefore been able to retain diluted voting rights following demutualisation. Safeguards are also needed to protect against the risk that once the firm becomes a proprietary company, it will need to pay a higher capital cost than when it was a mutual because it will need to pay dividends from funds that would otherwise have been available for policyholder benefits. However, windfall payments to policyholders are often perceived to more than compensate for this long term effect on their potential benefits.
56. A further effect of demutualisation is likely to be cultural change within the life insurer. Typically a firm that has demutualised is likely to need to become more accountable (to shareholders) and more commercial.
57. Some mutuals have no growth aspirations beyond their current, sometimes limited, target markets. In such cases, the pressure to demutualise is likely to be much lower than for other more growth oriented businesses.
58. The relative difficulty that mutuals face when trying to raise new capital means that the boards of mutuals need to pay particular attention to the capital planning process, systems and controls and overall risk management. This in turn should be reflected in their governance arrangements.

Question 14 (general governance principles for financial mutuals). 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?

Building societies

59. The Building Societies Act, which sets out the governance provisions in relation to building societies, is more prescriptive than the Companies Act but, in practice, the governance of life insurance mutuals has not suffered by comparison. Similar provisions to those in the Building Societies Act 1986 Act have been, in our experience, adopted by larger life insurance mutuals and embedded in their constitutions. It would be difficult to adopt a uniform approach to all life mutuals given that some of them are governed by private legislation. There might be a case for enhancing the governance provisions of friendly societies, along the lines of those adopted for the building societies sector, but it is not clear to us that there is any particular problem with the current governance of this sector.

General insurance mutuals

60. The population of general insurance mutuals is modest (less than 100 firms) and includes marine mutuals, professional indemnity mutuals, a number of other general insurance mutuals and some proprietary insurance firms that are run to varying extents along the same lines as mutuals. These firms generally operate in the wholesale market.

61. There are no special governance arrangements required for mutual general insurers relating to their mutual status. Under the FSMA regime, these mutuals are subject to the governance and systems and controls requirements applicable to general insurance proprietary companies.

62. The large mutuals tend to have a broader range of experience on their boards (as is the case frequently with proprietary companies). In similar fashion to some of the larger life insurance mutuals, certain large general insurance mutuals follow the Combined Code on a voluntary basis.

Question 15 (market structure). Do small, affinity group based, mutual firms face different governance issues from the largest firms in the sector?

63. The governance issues facing small, affinity-based mutual life firms will differ from the largest mutual firms because their business is likely to be less complex. Therefore, their governance structure will normally be simpler, in common with other small financial institutions. In general, the differences in governance between small and large mutuals will be similar to the differences in governance between small and large proprietary life insurers.

64. Smaller mutuals, whether affinity-based or otherwise, tend to be under greater cost constraints than larger firms and consequently may operate governance at what they perceive to be the minimum acceptable level (for example there may be minimal segregation of duties and board members may be of a lower calibre than for a larger firm). However, this issue is equally applicable to small proprietary firms and the costs of more elaborate systems could outweigh the benefits that they might bring.
65. There are some governance issues that are specific to affinity-based institutions. In view of the greater degree of commonality of interests amongst affinity partners compared with policyholders in a non-affinity mutual, there is a much greater incentive for them to become involved in the governance of the mutual and they are likely to be much easier to engage. However, even then there are potential drawbacks since, for example, there is the potential for disputes between affinity partners from different regions or business types within the affinity group, just as in other firms there can be conflicts between groups of policyholders or policyholders and shareholders. Again, the scale of the potential problem is proportionate to the size of the firm.
66. In affinity-based mutuals, particularly those set up with a social or ethical purpose, there may be a greater sense of loyalty amongst management which might improve accountability and performance. However, there is also a risk in such mutuals that the social or ethical objectives conflict with the prudent running of the life insurer and that the firm is run in an inefficient manner as a result.

If you would like clarification of any of the points made in this letter please let me know.

Yours faithfully