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Paul Myners
Myners Review
Room 4/16
HM Treasury
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Dear Mr Myners

Independent review of the corporate governance of mutual life offices: Consultation document

Thank you for your invitation to comment on the issues raised in the consultation document referred to above. We set out in the Appendix to this letter our responses to each of the questions raised in Section 4 of the Consultation document. Our comments reflect our experience in the life sector, both mutual and proprietary, as well as experience of other types of mutual organisation.

I trust you will find this response helpful in the context of your review.

Yours sincerely



Appendix

Our responses assume the continued existence and viability of life mutuals. We have concentrated our comments on governance arrangements. In summary, our arguments are that:

- Corporate governance arrangements for mutual life offices may not conform to best practice (though there are exceptions in the current market place with some life mutuals voluntarily adopting guidelines including the Combined Code).
- The Combined Code provides an appropriate framework with which to gauge best practice, in particular through the 'comply or explain' provisions, since the majority of principles are applicable whether the 'proprietors' of the firm are shareholders or policyholders.
- Enforcing best practice is particularly difficult in circumstances in which there is an absence of effective scrutiny by the investor community in the form of analysts and shareholders. We believe the regulator must take primary responsibility for ensuring standards of corporate governance are maintained.
- Reports should be made to policyholders / members of a mutual in the same way that reports are made to shareholders in a proprietary company.
- The accountability of the mutual's executive can be enhanced through such measures as encouraging greater policyholder participation in the election of members of the board, requiring adherence to relevant sections of the listing rules (in relation to disclosure of financial and other information and notifiable transactions) and requiring regular justifications of the mutual structure, eg through a continuance vote. Policyholders should appoint non-executive directors with appropriate qualifications, experience and industry knowledge to ensure an effective level of executive scrutiny.
- In order to implement proper governance and accountability it is crucial that appropriate information is provided to the board on a timely basis and those board members have appropriate skills to analyse the information and take high quality decisions. Appropriate information is likely to include 'achieved profits' financial reporting and some form of capital statement together with information on return on capital. Competence of directors should be assessed regularly by the FSA and provisions should be in place to ensure adequate training is available for non-executive directors.
- Policyholders play a dual role in a mutual life office, as customers and as owners. As a result they have an interest both in the performance of their individual policy, and of the organisation as a whole. While the two are clearly linked, policyholders typically focus on the former rather than the latter role. As a result, the executive of such organisations have enjoyed a lack of accountability and scrutiny, except where self-imposed. Addressing this requires both education of policyholders and an improvement in the quantity and quality of information with which policyholders are provided.

The specific questions raised are considered below:

1 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?

- The Combined Code provides effective guidance on corporate governance for organisations. While it is framed in terms of a dialogue between management and shareholders, the majority of its principles apply more generally in terms of the relationship between an organisation's management and its proprietors, be they shareholders or, in the case of mutuals, policyholders.
- Clearly there may well be aspects of the Combined Code which have less relevance to mutuals than to shareholder companies or no relevance at all. However, here we believe that the 'comply or explain' principle underlying the code provides an appropriate mechanism to apply relevant provisions only and explain the rationale behind non-compliance.
- There are also a number of aspects of the UK Listing Rules that could usefully be adopted to achieve corporate governance best practice and consistency. In particular:
 - Mutuals (of all sizes) should be required to make financial information publicly available on at least a six monthly basis
 - Certain transactions and events should either require approval of, or be notifiable, to policyholders (eg the equivalent of Class 1 and Class 2 transactions)
 - Disclosures required by the listing rules should be adopted, where relevant, by the mutual life sector

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

- It is our view that, in the absence of significant scrutiny by the investment community, the only effective means of securing compliance with best practice is through regulation. In particular, the FSA would need to become more involved in reviewing and enforcing compliance.
- We recognise that there may be resistance from the regulator in increasing the scope of their activities in this way. However many of the required tools are already in place, including:

- Regulations requiring the submission of the annual report and accounts with the regulatory returns
- The Listing Rules if applied to mutual life companies (see above)
- The 'Section 166' regime

3 *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?*

- Life mutual offices have traditionally suffered from a lack of accountability to their owners (policyholders) because of the basis on which members receive the return on their investments (ie bonuses on with profit policies). The form of financial reporting of mutuals needs radical overhaul so that they can demonstrate, as for listed companies, a clear link between earnings and distributions.
- Policyholder participation in board elections should be encouraged. For this to be effective, a rigorous and transparent voting system needs to be in place.
- The level of influence (eg through recommendations to policyholders) that existing management have over elections to the board should be eliminated.

4 *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?*

- In our view, non executives of life mutuals do not necessarily receive the quantity and quality of information and advice required to perform their roles to an appropriate standard.
- Non executives should, inter alia, have explicit rights of access to legal counsel, actuaries and accountants.
- Management information should regularly include clear and transparent financial information, including:
 - Achieved profits / embedded value information to assess the extent to which the company is creating or destroying value
 - Details of the amount and quality of capital held by the firm, its allocation to different business areas and the return on such capital

Given that such information would appear to be critical to the effective running and financial control of a life insurance operation, in theory these steps should have minimal additional resource implications.

- Guidance and training should be produced for non executive directors to enable them to discharge their responsibilities. Such guidance could be prepared through consultation between regulators and professional accountancy and actuarial bodies.

5 *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 their business?*

AND

6 *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?*

- Non executive directors cannot be expected to have a full technical understanding of the complexities of the business. However, policyholders have a right to expect that they are able to ask challenging questions of the executives and have the skills and experience to interpret the answers.
- To achieve effective governance, non executives should be drawn from a broad range of backgrounds which have some relevance to the organisation (eg regulation, financial reporting, insurance, marketing etc). They should include appropriately qualified individuals, as discussed above.
- Non executives should be regularly appraised on their performance and their contribution to governance of the organisation. It is likely that the FSA would need to monitor that such appraisals are carried out. The regulator should be tasked with ensuring that non executives are:
 - Fit and proper to serve on the board
 - Technically competent
 - Performing their duties adequately.
- Non executives should be given appropriate support to help them in their role. This should include:

- Relevant training
- Access to specialists, including independent actuaries
- Explicit rights to consult with independent legal counsel, actuarial and accounting advice. These rights should be enshrined in the company's governance documents.
- We acknowledge, however that non executives will continue to rely heavily on executive and specialist advisors for their information.

7 *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?*

- See response to question 3.
- An annual AGM which is able to attract a large number of policyholders would act as a check on executive directors. The timing and location of the AGM should be appropriate to the life mutual. For example, for large companies with a broad range of policyholders, the meeting should be held in a central location at a reasonable time of day. Smaller local entities should hold meetings within the local community.

8 *Lord Penrose says that in a life mutual "...it is the policyholders who are the source of risk capital for the enterprise". What does this mean for the relationship between a mutual life office and its policyholders?*

- In a mutual life office, policyholders act both as owners and as customers.
- Most policyholders do not consider themselves as providers of risk capital. Investments in with profits policies for example have, in the past, often been seen as risk free ways to invest into equity markets. There is room for further education to address this issue.
- Mutuals are, in comparison to listed companies, constrained in the sources of capital available to them which increases their reliance on their policyholders as providers of capital. This calls into question the continued viability of such organisations at a time when capital requirements in the industry are increasingly aligned to the risks of the business and consequently tend to be higher than those assessed previously.
- We believe that more and better information is vital to achieve effective engagement of policyholders. A key improvement would be to require reports to be made to policyholders / members of a mutual in the same way that reports are made to shareholders in a proprietary company.

- A specific recommendation would be that life mutuals should be required to produce an operating and financial review that is the same as that required for listed companies.

9 *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." In so far as corporate governance is concerned, do you agree?*

- While the FSA's actions since 1997 have moved in the right direction, there is a need to extend the regime that applies to listed companies more effectively to cover the mutual life sector.
- There are several examples of mutuals in the current UK market who successfully adopt best practice corporate governance guidelines. However, since the adoption of these guidelines is voluntary there are mutuals that currently do not.

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

- See response to question 2

11 *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?*

- The demand of shareholders of listed companies for return on equity targets to be achieved imposes a financial discipline on these companies which does not exist to a sufficient degree in mutual organisations.
- Large shareholders and analysts subject listed companies to intense scrutiny and challenge which is also absent from mutual organisations. While non executive directors provide a degree of challenge, this is often ineffective for the reasons described above.
- Mutual organisations should be accountable to their members (policyholders) in the same way as listed companies are to their shareholders. However, policyholders tend not to be of sufficient size or sophistication to challenge the executive effectively.
- Furthermore, mutual companies have traditionally been poor at providing financial information which is capable of facilitating effective challenge.

- Mutual organisations should improve the quantity and quality of information they provide to the public and to their policyholders. They should set targets and be monitored against achievement of those targets. It should be clear, for example, how much value is being created by the business (eg through use of achieved profits information) and what the break even point is for the business. Similar targets could be set in relation to standards of governance.
- Perhaps (by analogy to dividends in listed companies), mutuals could put their announcements of reversionary and terminal bonuses to a members' vote. There is of course a risk that this may encourage over distributions and it would be part of the regulator's enhanced role to prevent this.
- Clear and fair criteria should be adopted to ensure that each policyholder receives an appropriate opportunity to vote on issues affecting them.

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

- Mutual businesses face difficulties in the UK which call into question their ongoing viability, including:
 - Limited sources of additional capital, compared to listed rivals in particular
 - Particularly for the smaller players in the sector, an inability to exploit economies of scale
 - An evolving regulatory and capital framework which favours proprietary companies over life mutuals
- These factors should be offset to some extent by inherent advantages of a mutual. In particular, the absence of a shareholder as a separate stakeholder requiring compensation for the capital they place at risk reduces the financial burden of the company. In theory there should also be greater alignment of the business and its owners (although not necessarily of the owners and managers).

13 *What are the forces that drive de-mutualisation? What are the implications of de-mutualisation for members and customers?*

- Mutual life companies often contain 'orphan estates' which have built up in the company over a long period of time largely at the expense of previous generations of policyholders. De-mutualisation is a way of 'unlocking' and distributing some of this value.

- As a result, members may benefit from short term payouts ('windfalls') following a de-mutualisation. Against this there may be a reduction in the ability of the life company to use the orphan estate to fund enhancements to policyholder returns above those that would otherwise have been paid. Since it is not always the case that all policyholders are members (and there is often a lack of clarity over who the members are) it is likely that some policyholders may gain from de-mutualisation while others will lose out.
- It is likely that new mutual companies would find it difficult to be successful today. As noted above, it is questionable as to whether existing mutual companies retain a long term financial viability in the current environment. The de-mutualisation of these companies may well therefore be a rational, market driven trend. However, in many cases consideration should be given to the role such companies have played historically, and continue to play, in providing other services to the community other than financial return on capital.
- We believe that mutual companies should regularly review their current structure. This should include both financial and non financial analysis. Non executives should also be involved in questioning the applicability of the existing structure.
- There should be increased clarity around which policyholders are members of the company and what their precise voting rights are. A 'certificate of rights' could be issued to all policyholders.

14 *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 have traditionally been good at explaining their services to the community and the broader relevance and viability of their organisation. Smaller, affinity group based firms (see question 15) in particular would benefit from adopting some of these practices.

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

- Small, affinity group-based firms often exist for purposes other than maximising financial return on capital. They also fulfil other social needs of a particular community. This increases the complexity of any analysis of their ability to create value. Reporting to policyholders and the board in such organisations should focus on qualitative measures as well as financial results.

- 16 *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 are familiar with a Canadian membership organisation (similar to a UK Friendly Society) which requires a membership vote on all director appointments, though we are not aware that this is a Canadian regulatory requirement. It may be worth considering an option for UK mutuals whereby directors' appointments are, for example, delegated to aDear ClientName