

3

THE UK LIFE INSURANCE INDUSTRY

3.1 While life mutuals account for a relatively small – and, in recent years, shrinking – share of the life insurance sector (16 per cent)¹, they continue to have significant economic relevance, both in terms of the total funds managed (over £160 billion) and the number of members (9.7 million). There are, by comparison, approximately 11 million² individual shareowners in the UK, with total holdings worth £204 billion³.

3.2 This chapter gives an overview of the life mutual sector in the UK today, its constituent elements and principal characteristics. It describes the main attributes of a ‘mutual’ and considers the different sizes and legal forms of ‘life mutual’ in the UK.

WHAT WE MEAN BY MUTUALITY

3.3 Mutuality is a particular way of organising an economic enterprise. It differs from the more prevalent proprietary structure in terms of its governance, rights and objectives.

3.4 The main objective of a mutual society is the benefit of the society and its members (whereas the primary duty of a proprietary company is to its shareholders). Mutuals can be producer-owned (for example professional partnerships or producer co-operatives) or customer-owned (a group that includes all UK financial mutuals). In customer-owned mutuals, membership is generally contractually based, conferred by the purchase of a product to which a number of membership rights are attached. These rights are usually non-exclusive, in the sense that new members can typically join on equal terms, and non-transferrable.

3.5 Members’ rights generally include rights to benefit from any surplus generated by the society, rights with respect to the surplus on winding up and rights to call management to account by the exercise of a vote in a General Meeting⁴. The right to hold management to account does not mean that members are either entitled or required to take a role in the day-to-day direction of the enterprise. A fuller comparison of member and shareholder rights is given in Chapter 5.

3.6 A variety of legal forms of mutual engage in life insurance business in the UK. These are:

- Friendly Societies (either incorporated under the Friendly Societies Act 1992 or registered under the Friendly Societies Act 1974);
- Co-operatives incorporated under the Industrial and Provident Societies Act 1965;
- Companies incorporated under the Companies Acts and limited by guarantee;

¹ 16 per cent in terms of assets in the long-term business fund, valued using insurance accounts rules. Much of the life mutual data in this chapter was provided by the Centre for Risk and Insurance Studies at the Nottingham University Business School. The data was derived from Standard & Poor’s Synthesys database and refers to 31 December 2003. The data represents 53 of the 91 mutual life offices, and excludes only the small, non-directive friendly societies (see Annex B).

² Source: Proshare, 2002

³ Source: Office for National Statistics report on Share Ownership, published 10 June 2004.

⁴ For more information see “The legal form of business entities”, by Deakin and Cook for the DTI Company Law Review and “Issues in the governance of mutuals in the financial sector”, David T Llewellyn, December 2004

- One currently unlimited company;
- Companies incorporated by Private Act of Parliament.

3.7 Annex B gives a list of UK mutual life offices by corporate form. Some firms are not included in this list but are on the periphery of the life mutual sector. This includes, for example, firms that are subsidiaries of a building society or a company limited by guarantee. In particular, the Review notes Ecclesiastical Insurance, which has elected to join the AMI and is owned by a charity. The Review encourages such firms to consider whether the recommendations in this report are relevant to their business.

3.8 In respect of the heterogeneity of the life mutual sector, life mutuals differ as a group from UK proprietary life companies, which are all incorporated under the Companies Acts, or from Building Societies, which come under the Building Societies Act 1986.

ECONOMIC RELEVANCE OF LIFE MUTUALS

3.9 The life insurance industry is a significant part of the UK economy. At the end of 2003, UK life firms (mutual and proprietary together) held over £950 billion in assets on behalf of millions of savers, making the UK the largest life market in Europe⁵. Life insurance is also a major item of household expenditure. In 2001-02, 49 per cent of UK households purchased life insurance, spending an average of £919 per year⁶.

3.10 In 2002-03, UK households spent an average of £23 per week on life insurance, including pension contributions. This is about double what households spent on alcohol and tobacco (£11.40), just over half of what households spent on food and non-alcoholic drink (£42.70) and about five times the amount spent on household insurance (£4.50)⁷.

Market share

3.11 Mutuals' share of the UK life market has been in decline in recent years, largely due to the demutualisation of a series of large firms that began in the early 1990s⁸. Mutuals are nevertheless a significant presence in the UK market. In 2003, mutuals held £161 billion of life assets, 16.5 per cent of the UK total, wrote over £1.5 billion of new business, 13 per cent of the total, and received 13 per cent of total life premium income⁹. Three out of the top 20 life insurers by UK net premium income are mutuals¹⁰ and there are 11 mutuals with over £1 billion in long-term insurance assets. Life mutuals also have just under a quarter of the with-profits liabilities in the UK¹¹. (Annex C contains more detailed data on mutual and proprietary life offices.)

⁵ Source: Association of British Insurers.

⁶ Source: Expenditure and Food Survey 2001-02, The Office of National Statistics.

⁷ Source: A report on the 2002-03 Expenditure and Food Survey (revised 17/06/04), The Office of National Statistics.

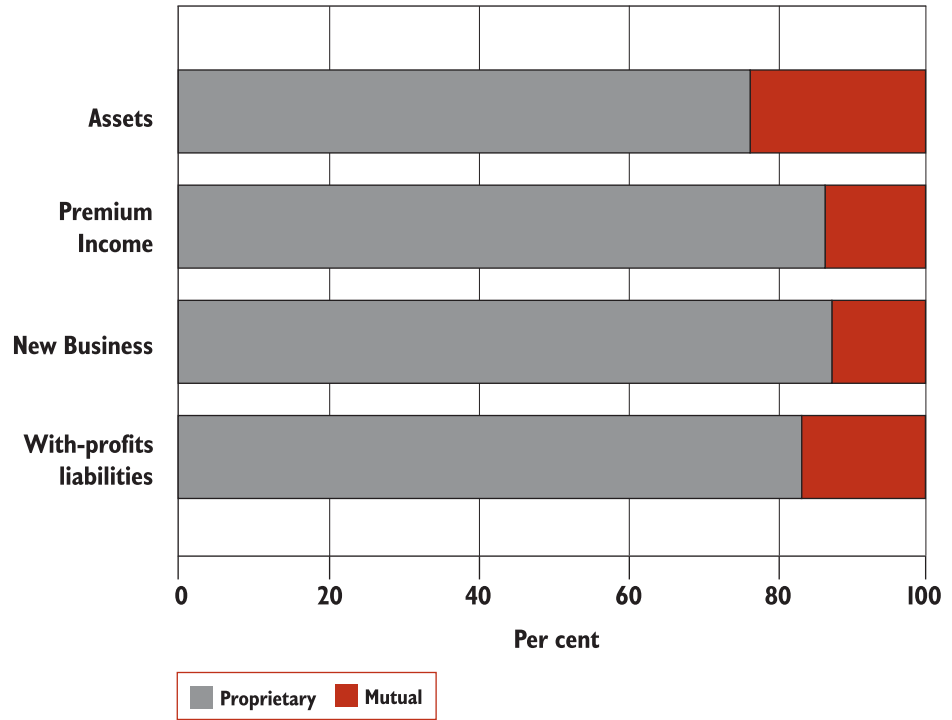
⁸ Annex C contains a list of the demutualisations.

⁹ Source: The Centre for Risk and Insurance Studies at the Nottingham University Business School. In comparison, the proprietary life sector manages £815 billion of assets, £93 billion of policyholders' premiums and wrote 86 per cent of new life business in the UK last year, which totalled over £10 billion.

¹⁰ Standard Life, Royal London and the CIS. Source: ABI Life Insurance rankings 2003.

¹¹ Source: The Centre for Risk and Insurance Studies at the Nottingham University Business School.

Chart 3.1: Mutual market share of life industry

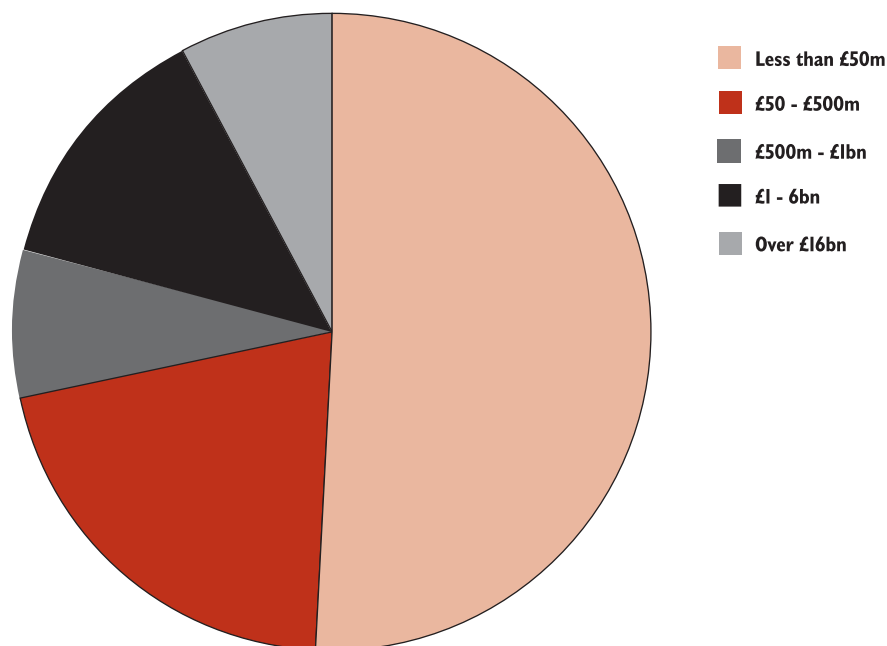


Source: The Centre for Risk and Insurance Studies at the Nottingham University Business School.

Size of life mutual offices

3.12 Most of the business of the mutual life sector is conducted by a small number of large firms. There are also a few medium size firms, and a much larger number of small firms, some of which are very small. This is in contrast to the proprietary sector, where there is a dominance of larger firms. The size of life mutuals in terms of assets is as follows:

Chart 3.2: Size of mutual life offices (in terms of assets)



Source: Data taken from The Centre for Risk and Insurance Studies at the Nottingham University Business School.

Number of members

3.13 Mutual life offices have a total of just over 9.7 million members¹², 5 million of which are members of friendly societies. Mutuals differ in which of their policyholders qualify for membership. Some restrict membership rights to those with with-profits policies, or to certain classes of with-profit policyholders. Others confer membership rights on all policyholders, which may include unit-linked life policies or those with general insurance policies or deposits. It is of course likely that some people will be members of more than one life mutual and this should be borne in mind when considering the 9.7 million figure.

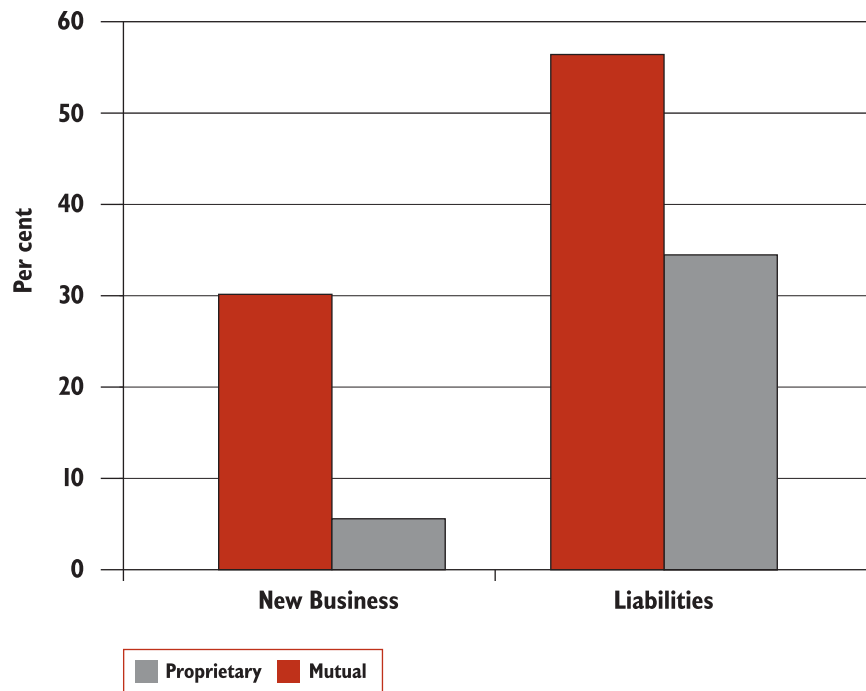
The importance of with-profits

3.14 Over the last 10 years, with-profit business has been consistently more important for mutuals than for proprietary life insurers. With-profit liabilities, as a proportion of total liabilities in 2003, amounted to 34 per cent for proprietary life insurers but 55 per cent for mutuals¹³. In addition, 30 per cent of new business written by mutuals is with-profits, in contrast to only 7 per cent for proprietary firms¹⁴.

¹² This figure was derived from data taken from the AFS Yearbook 2004-5, and from data supplied by the life mutual offices.

¹³ Source: The Centre for Risk and Insurance Studies at the Nottingham University Business School.

¹⁴ Source: The Centre for Risk and Insurance Studies at the Nottingham University Business School.

Chart 3.3: The importance of with-profits

Source: The Centre for Risk and Insurance Studies at the Nottingham University Business School.

3.15 In response to the Review's consultation document, several large life mutuals commented that mutuals tend to be constrained in their ability to raise capital because, by definition, they have no access to shareholder equity. As a result, mutuals are dependent on raising equity-type capital from their policyholders.

"In common with other mutuals, Royal Liver has no recourse to the equity markets to access capital but relies on the internal resources of its policyholders by way of the Free Estate."

With-profits business has traditionally been an effective way of generating this capital because in addition to giving policyholders a return on their investment, such products are designed to provide a contribution to capital reserves to support the future expansion of the business.

3.16 The last few years have seen a decline in the number of customers buying with-profits policies. Some consultation respondents commented on the potential impact of this on life mutuals:

"The diminishing sales of with-profits products will significantly damage life mutuals access to their traditional risk capital."

"The specific barriers to the success of mutual business in the UK are access to capital and the diminishing popularity of with-profits products."

In light of this, and as mentioned in Chapter 6, the Review considers that the AMI and the AFS could usefully give some consideration to whether any specific barriers exist for life mutuals in raising finance from the capital markets, which might warrant further consultation with the Government.

Mutual life insurance in other countries

3.17 Mutuals hold a significant market share in life and general insurance in many countries other than the UK. As part of the Review, we have sought to compare and contrast many of the factors affecting governance in UK life mutuals – law, regulation, governance codes and individual firms’ practices – with those found overseas. The contributions to the consultation that we received from outside the UK were particularly helpful in this respect.

3.18 While the principle of mutuality is fundamentally the same around the world, the size and nature of insurance and other financial mutuals’ presence in national markets depends on the strength of the local mutual tradition and on the national laws under which mutuals are incorporated. These laws determine not only governance and the membership rights of the kind described in paragraph 3.5¹⁵ but also the product markets open to mutuals. The UK is unusual in having mutuals incorporated under several different pieces of legislation. In terms of regulation, the UK is not exceptional in that mutual insurers are regulated no differently from their proprietary counterparts (although some differences do exist in the UK regulatory regime for friendly societies against other forms of life insurer).

3.19 Significant demutualisation of life companies has also taken place outside the UK over the last twenty or so years. This has been most noticeably the case in countries that have active capital markets, a tradition of equity finance and laws that allow the distribution of the residual upon conversion of a mutual. This process seems also to have been influenced by the general trend towards diversification or conglomeration in large financial services groups, which may often require more capital than is readily available to a mutual, and at the same time the extent to which mutuals are confined to specific markets. In addition, mutuals have often been attractive acquisition targets because of the strength of their brands and market position.

3.20 Whereas the causes and results of demutualisation in various countries have been the focus of considerable interest, governance in mutual insurers, though the subject of considerable academic literature, has generally received less attention from governments and regulators. The predominant view is that governance is more straightforward in mutuals due to the absence of shareholders, whose interests may otherwise differ from those of policyholders. As corporate governance receives greater attention in proprietary firms around the world the spotlight is likely to fall ever increasingly on mutuals as well; a process that has begun in some European countries and further afield.

3.21 One area in which international comparisons have been most informative is as a source of insight and examples of best practice for member engagement. A number of insurance mutuals in different countries are attempting to engage more with members as members, rather than simply as policyholders, as a means of differentiating their product from that offered by proprietary firms and highlighting the perceived benefits thereof.

¹⁵ See for example <http://europa.eu.int/comm/enterprise/entrepreneurship/coop/mutuals-consultation/doc/mutuals-legis-in-ms.pdf>

4

GOVERNANCE IN UK LIFE MUTUALS

4.1 This chapter explores what is meant by corporate governance, its main purposes, and why achieving good standards of corporate governance is important. These issues are explored in more detail in the paper written for the Review by Professor David Llewellyn¹. It also looks at corporate governance practice in the mutual life sector today, drawing on research commissioned by the Review.

DEFINING CORPORATE GOVERNANCE

4.2 “Corporate governance is the system by which companies are directed and controlled.”² In undertakings in which the management is separate from the owners, governance concerns the checks and balances that ensure that firms are run efficiently and meet the objectives of their owners, be they shareholders in a proprietary firm or members of a mutual. This particularly concerns the delegation of responsibility to management and the means by which the owners or their representatives hold the management to account.

4.3 The primary beneficiaries of good corporate governance are the firm and its owners. Firms whose standards of governance are high are all the more likely to gain the confidence of investors and customers and support for the development of their businesses. At the same time, good corporate governance has an economic importance that extends beyond the individual firm. How businesses operate and in whose interests they are run affects the allocation of resources across the economy and the efficiency with which resources are used.

4.4 The basic model for the operation of UK proprietary and mutual firms is the same. The executive runs the business day-to-day: the powers and responsibilities to do so are delegated to the executive by the board. The executive is answerable to the board for the operation of the firm and the exercising of the powers delegated to it. The board oversees the management on behalf of the owners as well as retaining some functions to itself (where the potential for conflict of interest precludes delegation, for example audit, nominations and remuneration). The board is ultimately answerable to the owners of the firm, in particular at the AGM. In proprietary firms, the transferability of ownership rights and the possibility of concentrated ownership gives rise to a market for corporate control.

4.5 In terms of this model, good corporate governance requires:

- That the right relationships (in terms of the delegation and retention of powers and the rights to control) are established between owners, the board and management. This issue is discussed further in Chapter 8. The relevant rights and responsibilities are in part determined by the law under which firms are established and the Articles of Association of the company.
- Effective internal monitoring and control of the company and management by the board.
- Effective external monitoring by owners. This requires adequate and timely information to be disclosed by the firm.

¹ ‘Issues in the governance of mutuals in the financial sector’, David T Llewellyn, December 2004, www.hm-treasury.gov.uk/myner

² ‘Report of the committee on the financial aspects of corporate governance’ (The Cadbury report) 1992, paragraph 2.5.

- Appropriate powers for owners to hold management to account. In terms of voting rights, these are again determined by the law under which firms are established and the Articles of Association of the firm.

4.6 The above description of governance and the pressures that are brought to bear on management does not consider the external forces on the firm such as:

- Market participants other than owners, such as IFAs, rating agencies, consumer groups and journalists all contribute to the external monitoring of firms.
- Withdrawal of capital, where possible, can act as a direct signal to management.

These wider forces, and their interrelationship with corporate governance are discussed in detail in Chapter 5.

CURRENT GOVERNANCE PRACTICE IN UK LIFE MUTUALS

4.7 The Combined Code, published by the FRC, is a set of principles and best practice for corporate governance for UK listed companies³. The Code is annexed to the UK Listing Authority (UKLA) Listing Rules and companies with an equity listing are required to adhere to the Code. The Code is not mandatory for other firms but is broadly accepted as a benchmark for other forms of undertaking (indeed around one third of mutuals responding to the survey described in the following paragraphs include a statement on corporate governance in their annual report that makes reference to the Combined Code). The Code deals with all of the generic issues raised in the previous section: the respective duties of the board and management (Code Sections A1 and A2 on the board, the chairman and the chief executive); the structure and operation of the board (A3 on board balance and independence, A4 on appointments, A5 on professional development, A6 on performance evaluation and A7 on re-election); the execution of duties reserved to the board (B on remuneration, C on accountability and audit) as well as section D on relations with shareholders.⁴

4.8 The Review commissioned a survey of corporate governance in mutual life offices broadly based on the Combined Code. Survey questionnaires were sent to all UK based life mutuals except non-Directive friendly societies⁵ – a total of 36 firms. To facilitate comparison with proprietary companies in line with the Review's terms of reference, 28 UK based proprietary life insurers, not all of which are quoted, were included in the survey. Where the life company is a subsidiary, the survey was addressed to the listed parent. Additional questions were included for mutuals only, covering numbers of members, qualification for membership, voting procedures and AGM attendance as well as on other areas of corporate reporting such as the directors' remuneration report. A full report of the results of the survey can be found on the Review's website⁶.

³ More background information on the Combined Code is given in Chapter 9.

⁴ This is not a complete description of the contents of the Code. Section 2 relates to institutional shareholders and annexed to the Code is the Smith guidance on audit and the Turnbull guidance on internal control as well as suggestions for best practice from the Higgs review.

⁵ The full definition of a non-Directive friendly society is given in the Definitions section of the FSA Prudential Sourcebook for Friendly Societies http://www.fsa.gov.uk/handbook/ipru_fs.pdf. In the current context, the most relevant part of the definition is "a mutual carrying on long-term insurance business whose annual gross premium income (other than from contracts of reinsurance) has not exceeded 5 million Euro for each of the three preceding financial years".

⁶ Survey of Corporate Governance in Life Mutuals, IFF Research, www.hm-treasury.gov.uk/myners

4.9 A total of 44 responses were received (some of which were incomplete), 29 from mutuals and 15 from proprietary firms. The mutuals that did not respond were all small friendly societies (where ‘small’⁷ is defined as in the research report as being less than £500 million in long-term insurance liabilities). The research report includes a detailed description of the responding mutual and proprietary survey populations in terms of their size and corporate structure. It is notable that the proprietary life firms responding to the survey are on average larger by long-term asset size than the mutuals and they are often large financial services groups with their life operations as a subsidiary. These are factors that will have a considerable effect on governance arrangements and this needs to be borne in mind when considering the direct mutual-proprietary comparisons made using the survey data.

Main survey findings

4.10 The main conclusion from the survey is that life mutuals as a whole are some way short of what might be regarded as full adherence to the Combined Code (setting aside for a moment the flexibility that the operation of ‘comply or explain’ allows to firms when deciding their mode of adherence). It is notable, however, that mutual life offices as a group are in many respects not significantly less compliant than their proprietary counterparts. There are some areas in which mutuals have adhered more closely to the Code than do stock firms (for example the proportion of chairmen who were independent at the time of appointment); elsewhere the reverse is true (for example with regard to the appraisal of the chairman and non-executive directors, which occurs less frequently in mutuals). There are also some parts of the Code for which the level of adherence in small mutuals in particular is low. It is common in such firms, for example, for the chief executive to be the only management representative on the board.

4.11 It should also be noted, however, that there are some mutual life offices that achieve a high level of compliance and can be regarded as examples for others to follow. In other words, achieving a high level of adherence to the Code is a realistic goal for mutuals as well as proprietary firms.

4.12 The remainder of this chapter discusses some of the key observations that can be drawn from the survey results. It should be noted that, given the small sample size as well as the data issues discussed above, the Review has used the output of the survey to inform its work rather than to drive its conclusions.

4.13 For the purposes of this discussion, Code adherence has been reported only in terms of the precise provisions of the Code and it has not considered where firms may have offered an explanation of their particular governance arrangements as an alternative mode of compliance. In addition, it should not be inferred that sections of the Code not discussed below are in any way less important than those that are.

Reporting on compliance

4.14 The first point to note is the level of reporting on Code compliance. An essential aspect of adherence to the Code is the production of a statement about the manner of compliance with explanations of departures from best practice. The existence of such a report might be regarded as a useful indicator of the level of adoption of the Code. The survey revealed that around a third of mutuals surveyed publish a statement in their

⁷ Note that in Chapter 7, ‘small’ is used in the context of non-Directive friendly societies, which all have substantially less than £500 million in long-term assets.

annual report. Although this practice is more common in the large mutuals surveyed, more than half of them do not produce this statement.

The board

Board meetings **4.15** Combined Code provision A.1.1 deals with, among other factors, the frequency of board meetings. It does not prescribe a minimum number of meetings but suggests that *“The board should meet sufficiently regularly to discharge its duties effectively”*. Yet while the survey revealed that the average was 9-10 board meetings per year for both mutuals and proprietary firms, there are two small mutuals whose boards held only three or four half-day meetings last year. The Review’s concern is that may not allow enough time for proper consideration of all of the issues that require the board’s attention.

4.16 In addition, meetings of non-executive directors without the executive, which are an important aspect of board operations and referred to in Code provision A.1.3, are often neglected in small mutuals, the majority of which hold no such meetings. All large mutuals hold at least one or two of these meetings each year.

The chairman **4.17** Current practice in the life mutuals surveyed is more closely aligned with the Code regarding provisions relating to the chairman. There were no instances in mutual (or proprietary) firms surveyed of the same individual holding both the roles of chairman and chief executive (or of combining one of these functions with that of the appointed actuary). 23 out of 29 mutuals stated that their chairman had been independent at the time of appointment and only one indicated that its chairman was a former chief executive.

Balance and independence **4.18** One area in which the anecdotal evidence suggested we would find a high level of Code compliance in life mutuals was board balance. Most firms did indeed have a majority of non-executive directors but only one third reported having a majority of independent non-executives judged according to the criteria set out in Code provision A.3.1. Indeed six life mutuals indicated that none of their non-executives would be classed as independent and, of these, three stated that none had been independent at appointment. In addition, only one third of mutuals (compared to more than half of proprietaries) had appointed a Senior Independent director. Overall, therefore, there is concern that the independent voice on a number of life mutual boards needs to be enhanced.

Length of service **4.19** The Code definition of independence pays due regard to non-executive directors’ length of service. Of the eight mutuals that were able to provide information on length of service, three indicated that current board members had served an average of more than 10 years. The longest serving mutual board members were one chairman and one non-executive both with a total of 24 years on their respective boards. And whereas most mutual board members (and all company directors) are subject to re-election every three years or less as per Code provision A.7.1, in six mutuals the interval is four or five years.

Recruitment **4.20** The manner of recruitment is important when seeking independent directors. For example, recruitment consultants, as a source of external input, were used half as often for non-executive positions by mutuals compared to proprietary companies – and were seldom used by small mutuals. Of concern was the observation that nearly half the small mutuals surveyed and two large mutuals do not have a nominations committee (constituted as described in Code provision A.4.1) to lead the process of board appointments. A quarter of mutuals did not have written terms of reference for their non-executives once appointed.

Executive representation 4.21 Executive representation may be lacking on some mutual boards. One of the supporting principles of this section of the Code states that “*to ensure that power and information are not concentrated in one or two individuals, there should be a strong presence on the board of both executive and non-executive directors*”. It seems, however, that the chief executive is the only management representative on the board in many, mostly small, mutuals. This was the case in 10 of 27 mutual firms responding to the survey, with two others reporting no executive representation on the board.

Performance evaluation 4.22 A formal and rigorous evaluation of the whole board, including the chairman and non-executives, is an important part of ensuring that each director continues to contribute effectively. This is not yet a part of the Code with which all firms comply. One third of large mutuals and two-thirds of small mutuals responded that they did not conduct an appraisal of the performance of the chairman and non-executive directors.

Information and professional development

Independent advice 4.23 Code provision A.5.2 requires that non-executive directors have access to independent professional advice at the company’s expense (the circumstances in which advice might be sought are discussed in Chapter 9). The survey asked about the availability of this facility in respect of legal, actuarial, accounting/audit, investment, recruitment, remuneration and governance advice. Half of the large life mutuals indicated that advice was not available on any of these topics. The small firms surveyed mostly offer the facility for some types of advice but few did so for all.

Induction and professional development 4.24 Around one third of mutuals provide no induction to their non-executives, as required by provision A.5.1 of the Code, and two-thirds give no formal training to non-executives joining the firm. In those firms that offer induction and training, it lasts on average only around two-thirds as long as that given in proprietary firms. Half of all life mutuals surveyed give no further training to non-executives in subsequent years.

Remuneration

4.25 Although section B of the Combined Code deals with the principles and practices of remuneration policy for firms, guidance on the directors’ remuneration report is no longer part of the Code, having been superseded for quoted firms by the Directors’ Remuneration Report Regulations 2002 – this is discussed in more detail in Chapter 9. The survey nonetheless asked about reporting on directors’ remuneration and whether this is subject to member approval. It would seem that two-fifths of mutuals vote on remuneration (but less than one third of small firms) and one third give a statement in the annual report that details individual directors’ remuneration.

The AGM and voting

4.26 The survey also explored voting arrangements in life mutuals. It appears that more than half the firms surveyed do not permit postal voting and a quarter do not allow proxy voting⁸. Five firms, three of which are large, allow neither proxy voting nor postal voting. All of these five had less than 200 members attending their last AGM. Proxy voting has been compulsory for proprietary companies under company law since 1948.

⁸ Since the survey was conducted, an EGM of Royal London Mutual Insurance Society voted to allow proxy voting.

4.27 There is also some diversity in the ways in which firms notify members of an AGM. Nine of the mutual firms in the survey do not send a notice of the meeting by post to members, relying instead on press advertisement, sometimes supplemented by other means, such as a notice on the firm's website.

CONCLUSIONS

4.28 The fundamental purpose of corporate governance is clearly as relevant in life and other mutuals as it is in proprietary companies. It is encouraging to note, therefore, that many important provisions of the Combined Code for Corporate Governance, which is the main benchmark in the listed proprietary sector, are the norm in some life mutuals. The survey evidence indicates, however, that some key aspects of best practice are less well established in the sector, in particular:

- Board composition may be inappropriate in some firms in terms of overall balance and the level of independent representation.
- The training and support for non-executive directors, including appropriate access to independent advice, may also be lacking.
- Disclosure of directors' remuneration, which is now best practice in companies and other sectors, is practiced by only a minority of firms.
- A small number of boards may meet insufficiently regularly to allow proper consideration of all relevant matters.
- Member voting arrangements are, in many cases, quite restrictive.

5

WHAT MAKES LIFE MUTUALS DIFFERENT?

5.1 The previous chapter set out in general terms why corporate governance is important and looked at corporate governance practice in life mutuals. This chapter examines the key differences between life mutuals and proprietary life companies that may be relevant to their corporate governance. In doing so it acknowledges that the firm's behaviour is determined both by its internal arrangements and processes as well as by wider market conditions and other external pressures.

Agency theory

5.2 There is a substantial body of economic literature that considers theoretical issues around the economic merits of different organisational forms. The issues in the insurance context are summarised by Diacon, O'Brien, Drake and O'Sullivan¹ in the following terms:

“The operation of life insurance companies involves three main parties: owners, managers and policyholders (customers). Mutual insurers differ from proprietary in that they do not have external shareholders. Therefore, while there may be conflicts in proprietary insurers between the interests of shareholders and customers, these do not apply to mutuals. Mutuals may therefore be able to concentrate on meeting the needs of their customers. However, we also need to remember the managers of insurers: it may be that proprietary companies are better able to control the potential conflict between managers and customers, e.g. because of the threat of takeovers.”

“Agency theory applied to insurance focuses on the incentive conflicts between the parties, and the manner in which these conflicts are controlled. Corporate governance mechanisms are potentially an important tool in managing these conflicts.”

5.3 Indeed it could be said that the mutual form is particularly appropriate for life insurance because of the nature of these agency relationships. As there is no need to have a separate supplier of capital independently of customers, it avoids the potential and unnecessary conflict between the interests of customers and shareholders (and the potential for inefficiency that may arise).

5.4 As in the case of proprietary insurers, a potential for conflict remains between owners and managers. A key question for this Review is how effectively mutual insurers control this conflict, and what scope exists for better corporate governance to provide a framework for managing that conflict. An important consideration in that context is the ability of, and the incentives on, members to monitor management and hold them to account to ensure they behave in the interests of members rather than pursue their own interests. The board of directors also plays a vital role in that regard.

¹ 'Mutual life offices: a contribution to the governance debate', O'Brien, Diacon, Drake and O'Sullivan, November 2004.

5.5 The Review recognises, however, that these are not the only forces at work. Insurers also face other, potentially very powerful disciplines, notably that of the competitive product marketplace. As one non-executive director put it:

“Given that life mutuals operate in highly competitive markets, and with limited capital, it has of course always been the case that they have faced strong pressures for effective market and economic performance. While they may not have had the discipline of equity market analysts and investors, their performance has faced strong scrutiny from financial advisers, from press commentators and from both existing and potential policyholders.”

5.6 The rest of this chapter considers these theoretical arguments in more depth and draws out some implications for the corporate governance of mutual life offices. A fuller analysis of the issues is to be found in Professor David Llewellyn’s paper, which is to be found on the Review’s website².

THE SPECIAL CHARACTERISTICS OF MUTUAL LIFE OFFICES

5.7 Mutual life offices have a number of special characteristics that are not found in other types of firm and which may influence optimal governance arrangements.

5.8 An important distinguishing feature derives from the nature of the business life mutuals conduct. In particular, life offices (be they mutual or proprietary) tend to operate on a relationship rather than a transaction basis, writing open contracts with long duration. This means that, unlike the simple purchase of an industrial product (such as a tin of beans), the behaviour of the firm after the initial purchase of the product affects the value of the transaction. This creates potential for opportunistic behaviour on the part of the firm, which underlines the need for effective monitoring of its behaviour in customers’ interests.

5.9 As the nature of the business is complex this may be a particularly onerous task. The specific characteristics of the products (for details see Box 1) mean that in practice the costs for the consumer in verifying the value of contracts (where this can be done at all) are high.

² “Issues in the governance of mutuals in the financial sector”, David T Llewellyn, December 2004, www.hm-treasury.gov.uk/myners

Box I Characteristics of financial services products

Significant differences exist between (some) financial and non-financial services and products. These special characteristics include:

- They are often not purchased frequently and hence the consumer has little experience or ability to learn from experience;
- There is no guarantee or warranty attached;
- If the firm becomes insolvent during the maturity of the contract its value may be lost, which is not the case with most other goods and services;
- Information on reliability is difficult to obtain;
- Value is not immediately clear at the point of purchase: the consumer cannot know if a bad product is being purchased. It may be a long time (if at all) before the consumer is aware of the value and faults of a financial contract. This limits the power of reputation as an assurance of good products;
- There is a lack of transparency: it is difficult to verify the claims being made by the seller. As a consequence it is often easy for a financial salesperson to conceal relevant information and/or mislead the consumer;
- The full cost of the product may not be known at the point of purchase.

5.10 The mutual form deals with some of these issues. Mutuals' members are necessarily also customers. And as they have no specialist group of shareholders and risk-takers who are remunerated separately, customers do not need to concern themselves with the risk that shareholders' demands for high returns will be at their expense.

5.11 There remains however some potential for the interests of managers to diverge from those of members. This needs to be monitored.

EXTERNAL MONITORS OF LIFE MUTUALS

The role of shareholders

5.12 In the case of a listed company shareholders can potentially exercise considerable influence over the company they own. Of particular importance is the role played by a small number of large shareholders who are for the most part institutional investors who invest savings in collective investment schemes such as pensions funds, insurance policies and unit trusts. In theory these institutional investors should maximise company performance by appointing high-quality boards of directors, who in turn incentivise and monitor the performance of managers. An adequate and transparent information flow would allow principals to hold agents accountable for performance. Shareholders are also a potential source of fresh equity in a time of distress. In practice however we recognise that large shareholders have not always been active in engaging with companies or effective in tackling poor company performance, though there are encouraging signs that they are doing so to an increasing extent. It is also the case that the non-executive directors on boards have not always effectively monitored company managers. In the light of this Sir Derek Higgs's recommendations³

³ "Review of the role and effectiveness of non-executive directors", Sir Derek Higgs, January 2003

– incorporated into a revised Combined Code in July 2003 – improve board accountability to shareholders and strengthen boards’ independence and ability to monitor management.

The role of members

Members’ interests **5.13** If we ask the question ‘who owns the company?’ the answer, in the case of a proprietary company, is quite simple: the shareholders own the company. Members in mutual organisations are often considered to perform the same role as shareholders. In many ways they do, but the situation is subtly different in the case of a mutual. Policyholders own their policies, which may confer upon them membership of the firm, and the rights of membership as defined by its constitution. As such they have contractual relationships with the firm that confer membership rights for so long as any individual contract they have with the firm remains in place, rather than direct ownership rights. Lord Penrose highlighted the complexity of this relationship in his report into events at Equitable Life:⁴

“Policyholders may be members or may be creditors of the company or both, with those relationships arising from their policies and defined in the constituent elements of the office by reference to those policies.”

5.14 Very often membership is, in effect, a by-product of product purchase. Research⁵ commissioned by the Review found that a minority of life mutual members (31 per cent) considered the mutuality of the provider when purchasing their policies.

5.15 Although they do not have the same ownership rights as shareholders, members do own mutuals, in as much as they would share in any final surplus of assets over liabilities in the event that the society were wound up. But this general idea of ‘ownership’ needs to be qualified as mutuals cannot properly be said to belong to current members as they have obligations to use assets left to them by previous members for the purposes of the mutual and to some extent they hold the current assets in trust for future members. Some respondents to the Review’s consultation exercise have expressed the view that, for this reason, a mutuals’ role is more akin to trusteeship. There is some truth in this, but if taken to its logical extreme, this analysis does not accurately represent the rights of members, particularly their rights to distribute surpluses, which is a fundamental aspect of mutuality. It would also fail to reflect their right to vote for conversion from mutual status.

5.16 These legal and ownership differences have implications for the nature of members’ interest compared to those of shareholders in a company:

- Mutual members’ interest is in the policy or policies they hold with the society. The nature of that interest often takes many different forms and as a consequence members’ interests can be in conflict with each other (this was demonstrated in the case of Equitable Life and the different interests of those members who did, and those who did not, have guarantees). A members’ interest is not transferable, and will cease to exist on exit. Neither is the interest of the member directly linked to the performance of the society (though there is some link for with-profits policyholders). In many mutuals members have a single vote, irrespective of the size of their investment and the length of time for which they have held it.

⁴ “Report of the Equitable Life Inquiry”, March 2004

⁵ “Attitudes of members of mutual life offices”, RS Consulting, December 2004, www.hm-treasury.gov.uk/myrnrs

- Shareholders will normally have risked their money in acquiring an asset that they can sell on the market at a price that reflects the performance and underlying net worth of the company. The size of their investment will normally be reflected in the number of votes they are entitled to exercise in a general meeting of the company. Voting interest is proportionate to the economic interest.

5.17 As discussed in more detail below, these differences in interest have some serious implications for the extent to which members can exercise influence on their firm.

Members' rights **5.18** Although their rights have different legal bases, in practical terms the functions performed by shareholders and members of mutuals in the governance of a firm are very similar, though the precise rights of members vary considerably between individual life mutuals as does the extent to which they are exercised. This depends in part on the legacy of the organisation, and in particular whether or not it has close ties with a specific affinity group. Other causes of difference are the Articles of individual mutuals, some of which are more permissive of member involvement than others.

5.19 What shareholders and mutual members have in common is:

- Voting rights. The precise extent of those rights and how they are delivered vary, depending on the legal basis of the entity (that is whether it is established under the Companies Acts, Friendly Societies Act or some other statute) and the firm's own Articles, but they all contain the same key elements. These include the right to vote and to requisition business at the firm's AGM;
- Access to financial statements. As insurance undertakings, all the different types of life mutual are within the scope of the Insurance Accounts Directive and required to prepare their accounts in accordance with the formats set out in that Directive. The Directive is implemented in the UK through different parts of the UK legislation for different types of undertaking. The extent to which they have to make those accounts available to members will be governed by each company's constitution.

5.20 Mutual members, like shareholders, are also given a role in overseeing some of the fundamental conflicts of interest that may arise in the governance of a firm, notably the:

- Appointment of directors. Members of mutual life offices tend to have the right to propose and vote on the appointment of directors (in much the same way as members of a proprietary company – that is as provided for in company's Articles). In some (but far from all) cases members can also remove a director before the expiry of his term of office by ordinary resolution;
- Appointment of auditors. Shareholders in a listed company have the right to vote on the appointment of an auditor at the AGM. In life mutuals, members similarly have a say in the appointment of auditors.

5.21 Where life mutuals currently differ from comparable proprietary companies (and indeed other financial mutuals) is in not permitting their members any say over:

- Major transactions. In the case of a listed company, shareholders must be notified in detail of all transactions that exceed a 5 per cent threshold (measured by assets, profits, turnover, consideration and gross capital) and the approval of shareholders in a general meeting is required for all transactions exceeding a 25 per cent threshold (measured in the same way). No standard provisions relating to control over major transactions appear to exist in the case of life mutuals, (although it would be possible for such provisions to be included in their rules). Such provisions do exist for building societies and co-operatives.
- Remuneration of Directors. Directors of a listed company have to prepare a remuneration report setting out the company's policy on directors' remuneration and which must include a breakdown of remuneration by director (including details of equity based incentives and pension benefits). The company's shareholders have an advisory vote on the approval of this report. The relevant regulations⁶ do not extend to mutual life companies limited by guarantee, but friendly societies are required to set out in their rules the manner of remuneration of their officers and their auditor. However there is no such requirement in relation to the committee of management of an industrial and provident society (its directing body), nor is there any requirement to disclose any remuneration figures in a society's annual report. Over 90 per cent of all building society members had the opportunity to vote on this issue at building society AGMs in 2004.

Limitations on the ability of members to exercise their voice

5.22 Although, as described in earlier paragraphs, members have rights to be involved in certain aspects of mutual life offices' governance, in practice their ability to exercise influence is severely constrained in some firms.

5.23 This is due in part to the structure of members' voting rights, which are typically not in proportion to the size of investment (though some life offices have weighted voting where those with larger investments do have more votes), and cannot be accumulated by purchasing votes in a market place. Consequently the membership rights are necessarily widely dispersed with no individual or group able (or indeed with the motive) to build up a controlling position. The result is that there is no mutual equivalent of the large or institutional shareholder in a listed company, and the concentrated source of shareholder influence that can deliver.

5.24 In practice this means that, if members are to exercise influence they must act collectively. It is also important that they should do so on a large scale. This is because, as noted above, many life offices have evolved in such a way that considerable potential exists for different classes of members' interests to conflict. Not all members share the same interests. As one respondent to the Review's consultation put it:

"In a mutual life office, there is no coincidence of interest between a member whose policy is about to mature and one who has just taken out a new contract."

⁶ Directors Remuneration Report Regulations 2002

5.25 Member influence should, therefore, be representative of the interests of all members, and action should be taken to guard against giving too much power to a small or self-selecting group of members. In the case of societies with strong affinity groups, such as trade unions, these issues may not present particular problems as the relevant affinity organisations can act as a broadly based conduit for members' views. But there are some substantial barriers to collective action by members of firms who are not organised in this way (difficulties that are, in many ways, shared by small shareholders). Specifically:

- The expertise and ability of individual members to monitor and to exercise influence are severely constrained;
- Mutual members may have relatively small stakes (though they may be large from the individual's perspective), so the cost to them of exercising influence may in any case be disproportionate to the benefits. Because the contribution of any one person is uncertain, it is rational for members to free ride on the contribution of others. They may consequently not be motivated to act

5.26 For all these reasons, there are limitations on what can realistically be expected of individual members in terms of their contribution to corporate governance.

5.27 As noted in Chapter 4, and explored further in Chapter 10, in many mutuals members' ability to vote is severely constrained. Other practical barriers exist. The dispersed ownership structure makes it difficult for members to form coalitions. It is easier (though perhaps not easy as it rarely happens in practice) for small shareholders to group together because there is a publicly available list of all shareholders in their company. Life mutuals do maintain lists of their members, though they are not always well maintained and access is not always easily achieved (indeed some have said to the Review that they are unable to give members access for data protection and commercial reasons).

The power of exit

5.28 In theory the relative weakness of direct member influence (and indeed individual shareholder influence) can potentially be mitigated by the exercise of the (often powerful) option of exit.

5.29 If a small shareholder is unhappy with the way the company is being run, rather than seek to influence the management of a company, it is relatively easy and cost-effective to sell.

5.30 Building society members may similarly opt to exit if they are dissatisfied. As exit by members can lead to a reduction in the capacity of the business, this action is potentially a more powerful discipline on the management of a mutual than the sale of shares in a proprietary company.

5.31 Within the mutual sector, life offices differ from building societies in that the transaction costs of exit can be prohibitively high. For many life mutual members, particularly those with longer-term policies, in practical terms the option of exit does not exist. This has significant implications for the relationship between the firm and its members, as well as for corporate governance. Members have a strong economic interest in the long-term performance of the firm, and even if they do not realise it, because they cannot exit easily, face a stronger incentive to play a part in its corporate governance. Managers, on the other hand, may face strong incentives to be responsive

to the needs of new customers, as they need to compete for their business, but face weaker incentives to listen to and respond to the needs of existing customers, who have little option but to remain with the firm. This makes it all the more important for existing members to make their voice heard.

5.32 For the members of mutual life offices knowing when to get out may also be difficult to assess. There is no easy point of reference such as a share price or an interest rate on a deposit or a loan. Life mutuals issue predominantly long-term contracts to customers, the final value of which tend not to be known, but depend on the actions of the firm. This makes it difficult for members to assess whether they might wish to exit and whether that would be in their best financial interests.

Equity market disciplines

5.33 In the case of a listed company, the shares have a market value which is immediately observable and known to all; there is a continuous re-valuation of the company. This is not the case with a mutual as there is no market in ownership claims and hence there are no price signals to guide management and alert owners and other stakeholders.

5.34 For the most part mutuals do not have external capital (though a few of the larger firms do have some debt) or tradable ownership rights in the form of shares. As a consequence there is no effective market for corporate control. Mutuals can merge or de-mutualise, but unlike listed companies there is limited scope for hostile takeover. A further consequence of the absence of external capital is that all transactions or guarantees are internal to the firm. This means that members are the ultimate risk takers even though they may not be aware of this. Members have a considerable interest in the performance of the firm, yet they cannot rely on powerful market influences to hold life mutuals' management to account. This reinforces the need for members to be involved in corporate governance.

5.35 Mutuals are not subject to the stock market discipline of the price of their equity and hence the cost of capital that is a powerful discipline on proprietary companies.

Other monitors of life mutuals

5.36 Respondents to the Review's consultation have argued that other disciplines on life mutuals help to compensate for the relative weakness of members' voice and the absence of equity market disciplines.

5.37 In particular respondents have pointed to the very important role played by IFAs in monitoring life mutuals. One respondent commented:

"The role of IFAs and organisations compiling their 'best advice' lists, should not be overlooked in respect of scrutiny of life offices. Over 50 per cent of Liverpool Victoria's business is sold through IFAs who play a significant role in advising their clients in regard to the bonus policies and capital strength of the various product providers, including mutuals."

5.38 Following discussions with IFAs, the Review is clear that in some cases IFAs do indeed devote some resource to this activity. It is also clear that, as monitors, they necessarily play a limited role. IFAs' primary interest is in surveying the relative merits of products that are available so as to advise customers. In doing so their interest will tend to be confined to relatively large firms and will tend to be based on the information of others (rather than information obtained at first hand). Not all mutual life offices choose to sell their products through the IFA distribution channel. Neither will IFAs necessarily choose to monitor all firms in the market, particularly smaller firms. As a consequence their oversight is partial. It is also concentrated on the interests of prospective rather than existing members (whose interests may differ).

5.39 Others have drawn attention to the role played by rating agencies. These agencies tend to provide to paying customers (life mutuals, brokers, 'sophisticated customers') financial strength ratings of larger mutuals, and debt ratings where relevant. While some agencies' assessments are very thorough, their coverage is partial as they have no incentive to rate firms (particularly smaller firms) where there is no market for their product. As with IFAs, their efforts are, for the most part, concentrated on larger firms.

5.40 Journalists and other commentators broadcast generic analysis and advice and some information, though this tends not to be systematic. Their monitoring tends to be based on publicly available information.

5.41 Life mutuals have an interest in the reputation of the life sector in general, and mutuals in particular. To date there has been no industry-based monitoring, though we hope this will change with the recent establishment of the AMI.

5.42 The Review's assessment is that the incentives, interests and influence of the other monitors of life mutuals cannot be guaranteed to compensate for the relative weakness of the ownership voice. A large number of respondents to the Review's consultation look to the FSA to fill this gap. Chapter 7 considers what role the FSA currently plays and might be expected to play in the future. As noted there, the FSA's role is necessarily and rightly confined to fulfilling its regulatory objectives. As such it cannot, and should not, substitute completely for the ownership interest of members.

Barriers to effective monitoring

5.43 In considering the relative force of external disciplines on life mutuals and proprietary companies, is also worth noting that the monitoring task – for all monitors – is made more complicated in the case of life mutuals by the characteristics of the sector.

Complexity 5.44 The complexity of the business can frustrate effective monitoring. In a proprietary company, the ultimate business objectives of the business, in terms of maximising shareholder value, is conceptually relatively straightforward. The success or otherwise of managers in delivering that objective is observable in the company's share price. As explored in Chapters 8 and 9, defining success in a life mutual is a more complex issue, as measurement is not straightforward. Conflicts of interest between managers and owners in strategic decision-making are less easily identified, and it can be more difficult to create management incentives that are aligned with members' interests.

Transparency 5.45 Life mutuals compete alongside proprietary insurers in the product markets, but the formal information publication requirements on mutuals are fewer than they are for comparable proprietary insurers, particularly those that are listed. Some mutuals choose to publish this information voluntarily, but as discussed in Chapter 4 some do not. Members, commentators, potential customers and their advisers may consequently not be as well informed about mutuals' activities. In particular, life mutuals are not subject to the information disclosure requirements in the listing rules on their compliance with the Combined Code and on major transactions, neither are they subject to regulations on the disclosure of directors' remuneration. These disclosures are given further consideration in Chapters 9 and 10.

CONCLUSIONS

5.46 A full discussion of the many differences between life mutuals and proprietary companies is to be found in Professor Llewellyn's paper². The analysis set out above serves to illustrate some of them. These differences are due in part to the particular characteristics of the two sectors, notably the absence of concentrated owner-influence among life mutuals. They are also partly due to different levels of formal legislative requirements, in particular life mutuals, unlike listed companies, face fewer information disclosure requirements and rules enshrining shareholder rights. This suggests the need for specific action to close the 'gap' in terms of:

- Disclosure of information to facilitate external monitoring;
- Measures to allow members their proper voice.

5.47 The precise nature of this gap and some recommendations to close it are set out in Chapter 10.

5.48 It is clear that for structural reasons there are limitations on how effective external monitors can be in holding life mutual boards to account. That said, their input can be an important source of information for non-executive directors, and enhance their effectiveness, as noted in Chapter 8.

5.49 A number of respondents to the Review's consultation suggest the FSA should fill the external monitoring gap. Chapter 7 considers in greater detail what role the FSA might play.

5.50 Others have suggested that, in practice, the relative weakness of external disciplines means that greater weight should be placed on the internal checks and balances within life mutuals. Chapter 9 considers this in more depth.

6

THE MUTUAL ADVANTAGE?

6.1 This chapter explores some issues around mutuality as a business form, its unique characteristics, and the purposes of corporate governance in that context.

6.2 The Review's starting point is that there are a number of theoretical reasons for the traditional prevalence of mutuals in the delivery of long-term financial services. There are also some wider public policy interests in a mixed system encompassing both proprietary and mutual businesses. This chapter seeks to evaluate the continued relevance of these considerations. It draws on this analysis to make some observations about the role of good governance in the successful operation of a life mutual as well as making some observations about the future of life mutuals in the UK.

History of financial mutuals

6.3 Financial mutuals in the UK have traditionally been grouped around long-term capital services such as housing finance and life insurance, where it is widely held that:

- The low cost of capital they enjoy by virtue of not needing to remunerate external suppliers of capital (in the form of a required rate of return on equity) can have a positive impact on the return to customers;
- There are potential efficiencies to be gained from a long-term investment strategy that is not unduly influenced by the short term demands of shareholders;
- Customers place a high value on stability.

6.4 As noted in the previous chapter, life mutuals can be held to possess certain inherent corporate governance advantages, as there is no need to have a separate supplier of capital independently of customers, it avoids the potential and unnecessary conflict between the interests of customers and shareholders. However, as with proprietary companies, a potential for conflict remains between owners and managers, which, in the event of poor accountability, can in theory give rise to inefficiency

Public policy interest in mutuality

6.5 A mixed system - with both proprietary and mutual firms – can serve wider public policy interests, because of the implications this has for providing a diversified structure and increased competition, and its consequences for financial stability. In particular:

1. In the event of a financial crisis, a mixed ownership structure in the financial system has a potentially stabilising influence as:
 - Mutuals and proprietary companies will tend to have different capital structures and different risk and investment portfolios;
 - It can in theory put a brake on the worst excesses of the herd instinct. Just as firms with the same corporate form will tend to behave in a similar manner, firms with different corporate forms may behave differently;
2. Financial mutuals are in theory capable of delivering a competitive challenge to their proprietary competitors.

6.6 As the recent report¹ of Parliament's All Party Building Societies and Financial Mutuals Group recently put it:

"A compelling case can be made for the pro-competitive presence of mutuals in the marketplace.

This is beneficial to consumers but would be more so were mutuals more effective at marketing their advantage. Mutuals face stiff competition in the marketplace and they will need to continue to deliver better performance than plcs because people will not choose to do business with them out of sentimentality."

Why are there fewer financial mutuals now than there were 10 years ago?

6.7 Financial mutuals now account for a lower share of their respective markets than they did 10 years ago. The mutual life insurance sector has seen 12 firms de-mutualise during the last 11 years (a list is at Annex C) during which time its market share has shrunk from a high of over 50 per cent² (in 1995) to 16 per cent in 2003³. A number of factors have contributed to this:

- The perceived advantages of mutuals may have been eroded to some extent by the advent of financial services regulation which has had the effect of evening up the relative security of mutuals and their proprietary equivalents. Progressively more sophisticated regulation has introduced prudential requirements for all life offices with the aim of increasing security as well as regulatory scrutiny of their dealings with customers. As such, it has sought to introduce for all firms some of the safeguards traditionally associated with mutuals;
- The evolution of a more developed market in financial products, offering more choices for consumers of different types of investment vehicles (such as collective investment vehicles), which have had a negative impact on the life insurance sector in general. It is worth noting in that context that proprietary companies have access to their shareholders for fresh capital in times of distress. Mutuals do not;
- Consolidation and diversification in the financial services sector has called for greater flexibility on the part of financial services providers – and mutuals are less flexible than their proprietary counterparts because they have no easy access to risk capital;
- For building societies, the Building Societies Act 1986, gave them the freedom, for the first time, to de-mutualise.

¹ The All Party Building Societies and Financial Mutuals Group, Short Inquiry, December 2004.

² "Mutual life offices: a contribution to the governance debate", O'Brien, Diacon, Drake and O'Sullivan, 2004.

³ Data provided by the Centre for Risk and Insurance Studies at the Nottingham University Business School.

Is demutualisation inevitable?

6.8 Perhaps in response to some of these developments, the 1990s saw a massive wave of de-mutualisations, with the consequence that the building society sector has now shrunk to less than a third of its original size. Similar pressures have affected the mutual insurance sector, whose capacity has been significantly diminished. Standard Life, the largest life mutual at present, has recently signalled its intention to recommend de-mutualisation to its members.

6.9 Common reasons cited for de-mutualisation are:

- To obtain greater and more flexible access to capital – this is usually associated with diversified business and adoption of more ‘plc’ type characteristics of the business, though in practice there is little evidence that many converters have taken great advantage of this subsequently. For life insurers, the development of level load products and the low margins in stakeholder pensions mean that more capital may be needed to write new business;
- To respond to restructuring in the financial services sector. In the insurance sector in particular a situation of increased competition and over-supply has led to industry re-structuring. Many former life mutuals are small relative to their proprietary counterparts and de-mutualised specifically to be taken over;
- To achieve a higher risk profile for the business. If a mutual wishes to diversify into riskier areas, then a shareholder structure, providing access to risk capital, may be more appropriate;
- To be free of legal restrictions (particularly the nature limits on building societies).

6.10 The other driver is short-term self interest among members and managers.

6.11 In a mutual the management has a choice over the allocation of the ‘profits’ of the business between its members and other customers or to use them to add to the entity’s reserves. When a mutual builds up reserves in this way, it increases the implicit ownership stake of members, but members have no access to it as its purpose is to provide long-term benefit to both current and future members. For current members, de-mutualisation is a means of unlocking this value.

6.12 Some have argued in their responses to the Review’s consultation that the desire to unlock that value - by members and management - has been a spur to de-mutualisation, particularly in the building society sector, where past practices had led, by the 1990s, to considerable reserves on the part of many societies. Managers may also be motivated by the better remuneration that tends to be on offer among proprietary companies. As one respondent put it:

“A number of commentators have found that a central consideration of boards and senior executives which opt for demutualisation is their own well-being. Typically salaries and fees in institutions that have demutualised are higher than in the predecessor mutual organisation...and add to the personal incentive of directors and senior management to convert. Finally a major force driving demutualisation has been the payment of windfalls to members of mutuals. It is questionable whether the votes required under building society legislation to

confirm a board conversion proposal would have been achieved without the associated payment by the mutual of large sums of money to the membership.”

6.13 Nonetheless de-mutualisation can in some circumstances serve the best interests of members, and they should have the right to decide on the future status of the enterprise. What is important is that any such decision should be fully informed. The Review accordingly emphasises the importance in any future motions to de-mutualise of members being fully informed by an exhaustive assessment of the full long term costs and benefits to members of the proposed action. As the All Party Building Societies and Financial Mutuals Group put it in their report:

“The evidence from previous de-mutualisations shows that they occurred against a backdrop of a relatively unsophisticated discussion about the merits of mutual status.”

6.14 The current regulatory regime goes some way in providing information to the members of life mutuals. The transfer of the business of a company is governed by a court process, which has certain prescribed features. These include a requirement for an independent expert to review the transaction and provide a report to the court and policyholders of the effect of the transfer. This looks at the economic effect of the transfer in terms of policy benefits. Qualifying policyholders would also normally vote on the transaction, in line with the memorandum and Articles of the company. Again, the vote requires a scheme circular to tell members of the nature of the deal and to explain to them the benefits. The FSA has powers to object to the court to seek to prevent a transfer. The FSA plays a more integral role in the process for friendly societies since the FSA has to take the decision rather than the court.

6.15 There remains, however, some potential for conflicts of interest to arise for management over their remuneration. In view of this, the Review recommends that, as a matter of best practice, any question of an increase in directors’ remuneration or compensation to directors in the context of a motion to de-mutualise should be put to members as a separate motion, as required under the Building Societies Act 1986⁴.

Recommendation 1

To mitigate the risk of conflicts of interest arising, any question of an increase in directors’ remuneration or compensation to directors in the context of a motion to de-mutualise should, as a matter of good practice, be put to members as a separate motion, as required under the Building Societies Act 1986.

⁴ Section 99(1) requires approval by separate special resolution for any payment by way of compensation to directors. Section 99A provides that where any director or other officer is to receive increased emoluments as a result of the transfer, an ordinary resolution approving this must be put to a meeting of the society.

Lessons from the building society sector

6.16 Despite suffering a considerable reduction in its strength in the 1990s, the building society sector is now stable and growing. This can be attributed to some extent to building societies adopting practices that prevent speculative de-mutualisations driven by short-term gain (such as charitable attribution of the proceeds). It can also be attributed to attitudinal changes within the sector, where the best societies have made good progress in:

- Adopting best-practice corporate governance;
- Re-establishing links with members;
- Demonstrably delivering good value.

6.17 As a recent KPMG study⁵ remarked:

“Building societies have been more effective than banks in recent years in holding on to their customers, who are far less likely to desert them. Many of them are extremely well-managed despite their size, and in some cases they are punching way above their weight.”

Where are the new mutuals?

6.18 In the UK, as noted above, de-mutualisation has been prevalent in recent years in the life insurance sector. The characteristics of the market are such that new life insurance firms are highly unlikely to be established. In particular, the need to finance a costly new business sales effort would make such an enterprise very capital intensive, and it would in practice be likely to need additional finance on top of what members could provide.

6.19 But if we look more widely, mutuality is thriving. A notable example is to be found in the growth of credit unions. Other interesting developments are to be seen in other countries.

6.20 A particularly interesting example is to be found in the US, where one of the most successful mutuals established in recent years is in the financial services sector. Vanguard⁶ – a mutual fund operator – was established as a mutual in response to a perception that the trustee model has broken down in large collective investment vehicles. There was a concern, in particular, about the balance of influence between independent board members (acting on behalf of investors in the fund) and that of shareholder-owned management companies who manage those investments, with the latter being “ruthlessly businesslike” in pursuit of their own profits. The founders of Vanguard argue that there is effectively a conflict of interest between these management companies (and their shareholders) and investors in the fund. The independent board members that stand between the investors and the management companies are often incapable of managing that conflict effectively.

⁵ KPMG, September 2004

⁶ www.vanguard.com

6.21 Vanguard's response to this analysis was to establish a new ownership and management structure, encompassing an independent board that is clearly focussed on the rights and interests of investors, within a mutual ownership structure. The benefits of this approach are that the fund need no longer contract with an external management company, but can instead perform the function in-house, and investors who own the management company, eliminate the conflict of interest.

Advantages of mutuals today

6.22 While, for the reasons set out above, some of the traditional advantages of mutuals may have become less relevant, many of their advantages remain important. In particular:

- As the Vanguard example demonstrates, conflicts between shareholders and customers of financial services can still be significant;
- They can offer customer focused delivery that is organised to serve members rather than to deliver returns to shareholders.
- They may have better access to customers – who are potentially more inclined to be engaged because of cultural sense of 'belonging' – to inform delivery of better products/services.

6.23 This engagement with customers is an important aspect of many mutuals' business. For example, one life mutual told the Review:

"Certain types of mutual business exist because of their mutual status and this includes Police Mutual. The nature of our engagement with the wider police family, our ability to provide financial education, and the significant cost advantages accruing from our volunteer network can only exist in a mutual organisation."

6.24 But they may also be less flexible than proprietary companies, as they are more capital-constrained. These issues have serious implications for the future of life mutuals, which in common with all life offices, face considerable commercial pressures.

6.25 Some have responded by adopting objectives that are similar to those of comparable proprietary companies, with a considerable focus on cost-efficiency and growth centred on offering a diversified range of products to new customers. Unlike their competitors, they will tend to have less easy access to capital. As a consequence, eventually, such firms may face pressures to de-mutualise, despite the additional costs, to achieve sufficient economies of scale to realise their commercial strategy.

6.26 In view of this, the Review considers that the AMI and the AFS could usefully give some consideration to whether any specific barriers exist for life mutuals in raising finance from the capital markets that might warrant further consultation with Government.

6.27 Because of the long-term and opaque nature of life business and the absence of any requirement on firms to consult members on major changes in strategy, in practice strategy decisions that may have serious consequences for the future status of a life mutual may be taken without members' knowledge or consent. We would not regard this as consistent with the spirit of mutuality, or respectful of members' right to decide on the future status of the mutual. In the light of this, we consider it important that members should be explicitly informed of major strategic changes, particularly those which may lead to some strain on its capital or involve substantial diversification of the business. Specific recommendations are made in Chapter 10, in particular on the publication of an OFR and on dialogue with members more generally.

CONCLUSIONS

6.28 Mutuality can in some ways be seen as the natural ownership form for long-term financial services such as life insurance, particularly with-profits. There is no need to have a specialist supplier of capital independently of the customers, and to do so would add complexity and a potential (and unnecessary) conflict of interest between the interests of shareholders and customers.

6.29 Yet, for the reasons set out in Chapter 5, as with proprietary companies, there remains some potential for the interests of managers to diverge from those of members. This potential source of conflict gives rise to the need for effective monitoring of the firm and proper accountability by the firm to its members. The aim of this Review has been to consider ways of meeting this need.

6.30 The Review's assessment is that the recommendations in this report will, at the same time, help life mutuals to play to their natural advantage. In particular measures to improve corporate governance should help to:

- Place more emphasis on developing long term strategies that are clearly focused on the strengths of the mutual structure and delivery of benefits to members. The quality of senior management, notably the non-executive input, will be important to this;
- Foster an environment in which life mutuals engage and, if necessary, re-connect with their members.

6.31 Looking to the future, life mutuals' advantage also lies in:

- Delivering - and being seen to deliver - good value. The challenge for life mutuals is demonstrating this value;
- Fostering mutuality among their members. Dealing, to the extent that it is possible, with the conflicts of interest among their members.

7

THE ROLE OF THE FSA IN CORPORATE GOVERNANCE

7.1 In his report, Lord Penrose made a number of suggestions regarding the role of the FSA in the monitoring and supervision of life mutuals. This was on the basis that:

“I have come to the view that the only acceptable approach to the many, and unpredictable, issues that are peculiar to the mutual life office is to ensure that they are subject to a level of regulatory scrutiny that takes account of the reality that, apart from the regulator, there is no-one who can intervene effectively to influence the activities of what must remain a form of organisation managed by a self-perpetuating oligarchy...”

7.2 Several respondents to the Review’s consultation document also advocated a greater role for the FSA in securing mutual life offices’ compliance with corporate governance best practice. These respondents recognised the nature of external monitors of life mutuals, as discussed in Chapter 5, and cited increased regulatory oversight as the best means to fill this gap. As one respondent put it:

“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 [with corporate governance best practice]”

7.3 In the light of such comments, this chapter looks at the various aspects of the regulatory regime that relate to corporate governance and considers recent developments in the FSA’s supervisory approach and a number of proposals for further changing the way in which the FSA monitors governance in life mutuals.

A NEW REGULATORY REGIME

7.4 In its response to the Review’s consultation, the FSA said:

“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.”

The current regulatory environment and the powers available to the FSA are very different to the regime that existed during most of the period studied by Lord Penrose in his inquiry into events at Equitable Life. Although the FSA does not have any specific powers in relation to corporate governance, it has powers to make general rules that can impose requirements on or influence a firm’s corporate governance arrangements. This is with the proviso that in using its rule making powers, the FSA must have regard to its statutory objectives¹ and the principles of regulation².

¹ Financial Services and Markets Act 2000 (FSMA), sections 2 (2) and 3-6.

² FSMA, section 2(3).

Box 2 The FSA's Objectives

Broadly, the FSA's statutory objectives are:

- Maintaining confidence in the UK financial system
- Promoting public understanding of the financial system
- Securing the appropriate degree of protection for consumers
- Helping to reduce financial crime

7.5 The current regulatory regime gives the FSA discretion when considering a firm's corporate governance arrangements, to take into account the size and complexity of the business and the skills and experience of the management. With that in mind, the FSA emphasises the responsibility of senior management to ensure compliance with regulatory standards, rather than having many prescriptive rules in this area.

7.6 The remainder of this section examines the FSA's rules and powers that give rise to its interest in corporate governance and explain the nature and extent of this interest.

Role of the FSA as gatekeeper to the industry

7.7 Subject to a small number of exemptions, before a firm can carry out regulated activities (such as life insurance) in the UK, it must be authorised by the FSA. As part of the authorisation process, the FSA vets firms to ensure they meet the threshold conditions³ that are laid down in the Financial Services and Markets Act 2000 (FSMA). Of relevance to corporate governance are the requirements on firms to have resources that are adequate to the business they wish to undertake and to conduct their business affairs soundly and prudently. Once firms are authorised, their compliance with the threshold conditions is monitored by the FSA and, if the FSA has concerns about the firms' ability to continue to meet those conditions, it provides grounds for the FSA to exercise formal powers to require firms to take appropriate remedial steps. Remedies could include recruiting expertise to the board, appointing extra non-executive directors to the board, employing staff or advisers with particular skills, modifying the governance structure of the firm, or even preventing the firm from taking on any new business until it had remedied the situation.

Approved Persons regime

7.8 The FSA also has to approve certain employees of authorised firms, such as the chief executive, executive directors and non-executive directors. Firms must seek the FSA's prior approval of these appointments and approval may be refused if the FSA is not satisfied that the person concerned is fit and proper⁴. In assessing fitness and propriety the FSA has regard to: honesty, integrity and reputation; competence and capability; and financial soundness⁵. Once an individual is approved, they must continue to be fit and proper and comply with the principles for approved persons⁶. Approval can be withdrawn if an individual fails to continue to meet the necessary standards. A number of respondents commented on this power:

³ FSMA, Schedule 6.

⁴ FSMA, section 61.

⁵ FSA handbook: The Fit and Proper test for Approved Persons (APER).

⁶ FSMA, section 64 and FSA handbook: Statements of Principle and Code of Practice for Approved Persons (APER).

“Overseeing and policing the Approved Persons regime gives the FSA considerable power when it comes to assessing the standard of a company’s corporate governance...”

“It is an important principle of general corporate governance that the directors of the enterprise have...sufficient experience, knowledge and training to carry out their functions. This is exemplified in the FSA fit person rules.”

7.9 The fit and proper test only gives the FSA the power to consider whether an individual is fit and proper. It does not enable the FSA to take account, for example, of the ability of other members of the board⁷. As a result of this, the fit and proper test is not a means by which the FSA can ensure the collective suitability of boards.

7.10 The Approved Persons regime can have a positive impact on the governance of a firm because of the effect of the principles with which approved persons, including senior management, are obliged to comply. As a result of these principles each board member has to:

- take reasonable steps to ensure that the business of the firm for which he or she is responsible is organised so that it can be controlled effectively;
- exercise due skill, care and diligence in managing the business of the firm for which he or she is responsible; and
- take reasonable steps to ensure that the business of the firm for which he or she is responsible complies with the relevant requirements and standards of the regulatory system.

7.11 A serious failure in corporate governance is likely to include a breach of one or more of the above principles and it is within the FSA’s power to take action against any board member implicated in the failure. This action could include withdrawal of approval, prohibition⁸, financial penalty, or a public statement.

Principles for businesses

7.12 The FSA’s ‘Principles for Businesses’⁹ are a general statement of the fundamental obligations of firms under the regulatory system. They are ‘rules’ and so are enforceable by the FSA, should the circumstances require it. The principles that are particularly relevant to the corporate governance of life mutuals are in Box 3:

⁷ FSMA, section 61.

⁸ FSMA, section 56. The FSA has powers to issue a prohibition order to stop an individual performing specified functions in relation to regulated activities and authorised firms. The prohibition may be narrowly defined, or it could prohibit the individual from working for any authorised person in any capacity.

⁹ FSA handbook: Principles for Businesses (PRIN).

Box 3 Principles for businesses

Principle 2: Skill, care and diligence

A firm must conduct its business with due skill, care and diligence.

Principle 3: Management and Control

A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

Principle 6: Customers' interests

A firm must pay due regard to the interests of their customers and treat them fairly.

Principle 8: Conflicts of interest

A firm must manage conflicts of interest fairly, both between itself and its customers, and between a customer and another client.

Systems, controls and the Combined Code

7.13 The FSA's 'Senior Management Arrangements, Systems and Controls' handbook sets out the responsibilities of directors and senior management. Firms are required to take reasonable care to maintain a clear and appropriate apportionment of significant responsibilities among directors and senior managers and to take reasonable care to establish and maintain such systems and controls as are appropriate to its business.

7.14 In assessing whether life firms' systems and controls are compliant, the FSA has regard to:

"..generally accepted principles of good corporate governance (including the Combined Code...) as it is reasonable to regard as applicable to it..."¹⁰

The impact of this statement is discussed further in Chapter 9. This guidance currently does not apply to friendly societies but when the FSA brings in its new integrated prudential sourcebook on 31 December 2004, directive friendly societies¹¹ will be within its scope¹².

7.15 The FSA's current guidance for building societies recommends having regard to the Combined Code, and also offers a sample code of governance¹³, which is a version of the original Combined Code adapted for the circumstances of building societies. The Building Societies Association has, however, recently produced an annotated version of the latest edition of the Code for its members¹⁴. The FSA has welcomed this initiative.

¹⁰ Interim Prudential Sourcebook for Insurers (IPRU (INS)), P3 Systems and Controls in Insurers, Annex A, A3.

¹¹ Non-directive friendly societies have been given more time before they need to comply with the Integrated Prudential Sourcebook (PRU). In the interim they will be subject to the Interim Prudential Sourcebook for Friendly Societies (IPRU(FSOC)), as outlined in the FSA's CP04/13, paragraphs 3.48 to 3.55.

¹² IPRU (FSOC) contains guidance on corporate governance best practice for friendly societies, but does not make any reference to the Combined Code.

¹³ Interim Prudential Sourcebook for Building Societies (IPRU(BSOC)), Annex 3A to Chapter 3.

¹⁴ The Combined Code on Corporate Governance: BSA Guidance for Building Societies.

Supervisory approach

7.16 The FSA has a risk-based framework for supervising firms and assessing the risks they pose to consumers. Regulated firms may be familiar with the term ARROW¹⁵ in this context, which is the FSA's methodology for carrying out risk assessments. As part of that process, the FSA may form a view about whether a firm complies with the threshold conditions.

7.17 The amount of supervisory effort devoted to a particular firm depends both on the size of the firm (and, therefore, the potential impact were it to fail) and an assessment of the risks to consumers. The very largest firms are subject to close and continuous supervision with regular risk-assessment visits, whilst others receive a visit every two or three years. Low-impact firms are supervised by a combination of baseline monitoring (the receipt and monitoring of returns and notifications) and thematic reviews to monitor compliance standards; they do not have an individual risk assessment.

7.18 A risk assessment involves identifying business and control risks as well as external risks that may affect the firm. These risks are then assessed in terms of how they may affect the FSA's statutory objectives. Corporate governance is one of the risk elements the FSA considers in its assessment of firms. When looking at corporate governance in this context, the FSA has regard to a number of issues including board composition and effectiveness, committee structures, the role of non-executive directors and, for listed firms, adherence to the Code. The output of a risk assessment is a risk mitigation programme that sets out the issues the FSA has identified and actions to be taken by the firm to address these issues.

7.19 The FSA is also currently reviewing its supervisory approach to corporate governance and considering how it can make improvements. In particular, as part of its wider programme of staff training to support its regulatory reforms for insurers, it is looking at providing extra training and guidance for supervisors on the role of non-executive directors, the collective suitability of boards and management information practices. The Review supports this project and believes that the FSA is right to look at these aspects of governance in supervised firms as a matter of routine.

7.20 In addition, as discussed in more detail in Chapter 9, the Review encourages the FSA to stay close to developing thinking on board effectiveness reviews across the corporate sector.

Information gathering powers

7.21 If the FSA is concerned about the governance of a firm, it has information gathering powers it can use to:

- Obtain documents – such as board minutes and papers – in order to inform a judgement about the conduct of the board and the competence of its members¹⁶;
- Commission a 'skilled person's' report to review current governance and make recommendations of how governance could be improved¹⁷; and

¹⁵ Advanced Risk Responsive Operating Framework.

¹⁶ FSMA, section 165.

¹⁷ FSMA, section 166.

- Review the conduct of individuals – including board members – who perform controlled functions¹⁸.

The FSA has wide discretion to exercise these powers where it considers there is good reason to do so.

The FSA's approach to regulating mutuals

7.22 In their response to the Review's consultation, the FSA commented that:

"Mutuality has not, itself, been a major factor in determining our approach to regulation, though we do of course take it into account where relevant".

"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 [FSMA] does not give us a direct role in protecting policyholders as owners of firms."

7.23 This suggests, for example, that the FSA would not intervene were a life mutual to act in a way that was not in accordance with its Articles (perhaps in relation to member voting) unless this action by the firm caused detriment to policyholders as customers to the firm or was likely to impinge upon another of the FSA's statutory objectives. In practice, though, it may be unlikely that the policyholder as owner would suffer detriment without the policyholder as customer also suffering.

RECENT INITIATIVES

With-profits review

7.24 In Spring 2001, the FSA announced that it would be reviewing with-profits business, covering both mutual and proprietary sectors. Since then the FSA has published a series of consultation papers containing a number of proposals, some of which have now come into force, that are likely to have an effect on the corporate governance arrangements of with-profits firms¹⁹. Some of the changes are specifically aimed at with-profits business, and therefore likely to be of particular interest to mutual life offices. However, many of the changes have been introduced as part of the FSA's wider reform of insurance regulation and so apply to insurance firms more generally.

7.25 Box 4 contains a summary of the FSA's changes in relation to publishing principles and practices of financial management and establishing with-profits committees. Box 5 sets out changes in relation to actuarial advice to the board.

¹⁸ FSMA, sections 167 and 168.

¹⁹ The With-profits Review website can be found at http://www.fsa.gov.uk/pubs/other/with_profits

Box 4 Recent FSA initiatives**Principles and Practices of Financial Management (PPFM)**

Since April this year, with-profits firms²⁰ have been required to disclose their PPFM. The PPFM documents how firms exercise their discretion in managing with-profits funds. Directors have to certify each year that their with-profits business has been run in accordance with the PPFM and report to policyholders on how the firm has complied with its PPFM obligations, the exercise of discretion and how they have dealt with competing or conflicting rights and interests of policyholders.

It is expected that the PPFM will help to improve the way in which some firms manage and control their with-profits business. It may also act as an additional constraint inhibiting firms from taking decisions on the use or distribution of life funds that might be inconsistent with previous undertakings to policyholders.

The FSA is also proposing that firms should produce a consumer friendly version of their PPFM. The purpose of this document is to provide policyholders with more information to help them make informed decisions about their with-profits investments.

With-profits committees

The with-profits review also dealt with the possibility that firms might seek to establish with-profits committees. While there is no requirement to have such committees, the guidance suggests that if a firm were to set up a with-profits committee, it should be composed of non-executive directors, and may include persons who are external to the firm. Its role should be to consider, and provide the governing body with an independent assessment of, the firm's compliance with the PPFM and how any competing or conflicting rights and interests have been addressed. Any with-profits committee would not be a decision-making body; responsibility for decisions on the use of discretion and for the firm's report to with-profits policyholders would remain with the governing body itself.

The FSA also suggests alternatives to the with-profits committee that firms may consider, including asking an independent person with appropriate skills and experience to report to the board on these matters or, for small firms in particular, commissioning a report from a non-executive director.

²⁰ Excluding non-directive friendly societies.

Box 5 Actuarial advice to the board

Following its with-profits review, the FSA is introducing major changes relating to the provision of actuarial advice to the board. One of the main themes to this work is that the accountability for actuarial matters should rest with the board. As the FSA states in CPI 67²¹:

"Directors will not be able to claim that the responsibility for valuing the liabilities lies outside their jurisdiction. They will not be able to say they relied on the work of an actuary."

A new **actuarial function**, which is not limited to with-profits, has been established. The role of this person is to:

- Advise the board on the methods and assumptions for the valuation of policyholder liabilities;
- Calculate liabilities according to the methods and assumptions agreed by the board and report thereon;
- Monitor the financial condition of the firm; and
- Advise on capital needs to support the business.

The actuarial function holder is an Approved Person under the FSA's regime, which distinguishes the holder from other actuaries in terms of regulatory responsibility and accountability.

The directors' certification of the annual regulatory returns now includes a statement from the board that they have taken actuarial advice from the actuarial function holder on the valuation of policyholders liabilities and that they have paid due regard to it.

There is also a new **with-profits actuary** role. This person is to provide actuarial advice to the insurer's senior management and a report to the board on the use of discretion in the with-profits business. This report focuses on the fair treatment of policyholders. The with-profits actuary will also disclose to policyholders whether their interests have been appropriately considered in areas where discretion is exercised and thus on the firm's compliance with the PPFM. The with-profits actuary cannot be a board member but the actuarial function holder can. If the same person fulfils both roles, the individual concerned cannot be a board member.

A third new actuarial role, which came out of the Tiner review of insurance regulation²², is that of the **reviewing actuary**. The audit review of regulatory returns is now to cover areas previously the responsibility of the appointed actuary. The actuary advising the auditor – the 'reviewing actuary' – reports directly and privately to the auditor, giving his or her views on the reasonableness of the valuation of liabilities by the firm, the methods used and the economic, market and actuarial assumptions on which the calculations are based.

The rules establishing these new actuarial roles will take effect from 31 December 2004, when the new integrated prudential sourcebook for insurers takes effect.

²¹ Annex E, paragraph 59.

²² "The Future Regulation of Insurance: a progress report", October 2002.

New prudential rules for life insurers

7.26 As mentioned above, at the end of 2004 the FSA is introducing new prudential rules for life insurers, which changes the way life insurance firms report on and assess their capital positions. The new rules contain two new concepts - realistic reporting and individual capital standards, which are explained in Boxes 6 and 7.

Box 6 Realistic reporting

The FSA's new realistic reporting arrangements apply to the 37 largest with-profits life insurance firms, which between them operate 46 with-profits funds. Nine of these firms are mutuals. The new rules take full effect from the end of 2004, when firms are required to publicly disclose their realistic position and reserving assumptions as part of the annual regulatory returns. Firms will also report privately to FSA on a half-yearly basis.

The realistic approach aims to ensure that firms have enough financial reserves to cover all of their liabilities in future. For example, firms who have indicated that they will pay terminal or final bonuses to policyholders will be required to make a more accurate assessment of these promises and to reserve sufficient funds to cover them. The new arrangements also reflect other factors, such as the impact of planned management actions and other changes to the valuation techniques that have to be used.

The new arrangements should mean that there is an improvement in the clarity of the strength of the with-profits fund and an improvement in comparability of results between firms. In terms of corporate governance, all board members (and external monitors) should have greater clarity over the financial position of the firm and factors impacting on this position.

Box 7 Individual capital adequacy standards (ICAS) framework

The ICAS framework requires each life firm, mutual and proprietary, to make an individual assessment of its capital needs. In addition, the FSA also proposes to give firms individual capital guidance reflecting the FSA's view of what adequate capital would be for their particular business. In its consultation document²³ the FSA said:

"The purpose of a requirement to self-assess capital needs is to emphasise the responsibility of the management of each life firm to ensure the firm holds financial resources that are appropriate to its particular business mix and plans."

²³ CPI95, 'Enhanced capital requirements and individual capital assessments for life insurers'.

Closed funds

7.27 The closure of with-profits funds to new business is not a new phenomenon, but over the last few years the number of funds closing and the size of the policyholder funds involved have risen. Concerns have been raised over the fair treatment of policyholders in closed funds and the FSA responded to these and other concerns in a paper published in September 2004²⁴. This reiterates that all regulated firms are required to treat their customers fairly and this is no different for firms with closed funds; that during the period of run-off, closed funds are subject to the same regulatory regime that applies to open funds; and that firms are expected to maintain appropriate standards of corporate governance with respect to both closed and open funds.

7.28 In addition, new proposals currently under consultation²⁵ seek to address some of the unique governance issues presented by closure of funds. Subject to the results of the consultation, the proposed requirements in Box 8 are expected to come into force in mid-2005.

Box 8 Closed Funds: FSA proposals

Notification to policyholders on fund closure

One of the FSA's particular concerns in relation to closed funds is the considerable inconsistency over information that policyholders currently receive from their insurer when a fund closes to new business. The new requirements for the PPFM would require the firm to contact policyholders if the PPFM was likely to change. In addition, to improve the information to policyholders, the FSA is proposing that firms should notify policyholders within 28 days of:

- the reasons for closure;
- any proposed changes to investment strategy;
- how the closure may affect policyholders; and
- options open to them and any cost implications.

Run-off plans

As a result of the different and/or additional risks that may arise when a with-profits fund closes to new business, the FSA is also proposing to require firms to submit a detailed run-off plan to it within three months of closure. This should describe, amongst other matters:

- the firm's strategy for managing the run-off of the fund;
- the risks associated with fund closure;
- how the firm intends to ensure a full and fair distribution of the closed fund and any inherited estate; and
- any implications for the firm's PPFM.

²⁴ Insurance Sector Briefing: The regulation of closed with-profits funds.

²⁵ CP04/14, "Treating with-profits policyholders fairly".

7.29 The Review welcomes this very important initiative, and believes that the FSA is right to review this area.

Strengthening the governance of retail funds

7.30 In May of this year, the FSA announced that it intends to do further work on strengthening the corporate governance of retail funds as a means of sharpening the accountability of fund managers²⁶. The FSA suggested that this might entail the development of an investors' champion, to receive and assess disclosures from the fund manager on behalf of the fund's investors as a whole. The FSA also commented that it may wish to consider the position of other types of retail managed fund, such as investment trusts and the funds of life assurers. This is further evidence of the FSA's acknowledgement of the importance of governance and the Review encourages the FSA in its work in this area.

ENHANCING THE MONITORING OF GOVERNANCE BY THE FSA

7.31 This section considers a number of suggestions made for changes to the way that the FSA monitors governance of regulated firms. These include the recommendations made by Lord Penrose in his report, as well as issues raised by respondents to the Review's consultation document. The role of the FSA in promoting adherence to the Combined Code in life mutuals is discussed in Chapter 9.

Power to appoint an adviser from a panel of experts

7.32 The first suggestion by Lord Penrose was that the level of regulatory scrutiny to which mutual life offices are subject should be increased by giving the FSA the power to appoint an adviser to the board of a life office from a panel of experts²⁷. He envisaged the advisers having access to members of the board and board minutes and the power to report to FSA.

7.33 The majority of respondents to the consultation who expressed a view on this issue expressed serious reservations. For example, one life mutual said:

"We believe this would present the FSA with a conflict of interest impossible to resolve."

7.34 The Review agrees that there is a significant risk that the expert adviser would be someone who might be perceived by members to have many of the functions of a director but without the same legal duties or accountability to members. It would also be inappropriate for the FSA to be placed in a position whereby it could be held liable if firms failed, either because the failure occurred despite expert advice or because it had not appointed an expert adviser to a firm that subsequently failed. Requiring the regulator to determine when the firm needs expert advice would also undermine the FSA's aim, with which the Review agrees, of ensuring that responsibility for the proper running of firms rests with the senior management. Therefore, after careful consideration of this proposal, the Review concludes that the difficulties would be insurmountable.

²⁶ PS04/13, "Bundled Brokerage and Soft Commission".

²⁷ See Chapter 20, paragraph 55.

7.35 It is not clear, moreover, that the powers envisaged for the expert adviser would give the FSA greater access to firms than is permitted under its current investigative powers (see paragraph 7.21). It is questionable, therefore, whether this measure would improve the ability of the FSA to monitor firms' boards.

Board composition 7.36 Lord Penrose also advocated a greater role for the FSA in requiring changes to the board to address major gaps or imbalances in directors' collective skills or experience²⁸. As discussed earlier in this chapter, since the FSMA came into force, the FSA has a combination of powers, principles and guidance that enable it to require firms to address shortcomings in the composition of its senior management, to refuse applications for approval and to withdraw existing approval. The Review is encouraged to note also (see paragraph 7.19) that the FSA, in the context of its review of its supervisory approach to corporate governance, is looking at how it considers the collective suitability of boards. The Review strongly encourages the FSA to have regard to the aggregate skills of the board rather than just those of individual directors. The issue of board composition is also discussed in Chapter 9 in relation to the Combined Code.

Meetings with non-executives 7.37 A further topic raised in the course of the consultation was the value of meetings between FSA supervisors and non-executive directors without the executive present. It was suggested that this should be common practice, so as to ensure that non-executives have a good grasp of issues of concern to the regulator. The Review understands that such meetings can and do take place, but not as a matter of routine for all firms. The Review takes the view that increased interaction between the regulator and non-executives would be of reciprocal benefit. The responsibilities of non-executives are to a considerable degree aligned with the objectives of the regulator. The form this contact might take is discussed further in Chapter 8. The Review recognises that it would be impractical for the FSA to meet frequently with the non-executives of all life mutuals, but this channel of communication should be regarded as a valuable part of the interaction between the regulator and supervised firms. This can be seen as an important complement to improvements in the information provided to non-executives, which are discussed in Chapter 9.

Recommendation 2

Given the importance of the role of non-executive directors in life mutuals, meetings between FSA supervisors and non-executive directors of life mutuals (without the executive present) are a valuable part of the interaction between the FSA and supervised firms. The Review takes the view that increased interaction between the regulator and non-executives would be of reciprocal benefit.

CONCLUSIONS

7.38 It is clear that the nature of regulatory oversight of life mutuals and other firms has changed considerably in recent years. A greater focus on governance has been part of this. The Review is very encouraged to note the FSA is already reviewing its supervisory approach to corporate governance and considering how it can make improvements. The Review urges the FSA to build on current efforts to secure good governance as an essential step towards ensuring that firms are run in the appropriate

²⁸ See chapter 20, paragraphs 52 and 53.

manner. This does not require any changes to FSA powers, nor does it imply that the FSA should be considering matters from the perspective of ownership.

7.39 An effective board is essential for a firm to be run properly. It is particularly important, therefore, that the regulator should monitor the overall effectiveness of boards rather than just the suitability of individual directors. In addition, the FSA should be seeking contact with non-executive directors as a regular part of their interaction with supervised firms. This should help both the regulator and the non-executives to become more effective.

8

THE ROLE OF NON-EXECUTIVE DIRECTORS

8.1 In his report into events at Equitable Life Lord Penrose raised a number of fundamental questions about the relationship between the Board and specialist members of the executive management team and in particular the extent to which non-executive directors can or should be expected to gain a true understanding of a complex business such as Equitable Life. In particular, he observed that:

“The Board at no stage got fully to grips with the financial situation faced by the Society: information was too fragmented, their collective skills were inadequate for the task, and there were no effective arrangements for ensuring that there was detailed examination of, and onward reporting to, the Board on actuarial reports”¹

8.2 Since the role of non-executive directors is an important component of the corporate governance of mutual life offices, and the terms of reference for the Review address the question of board accountability in mutual life offices, the consultation document raised a number of specific questions in regard to this area (see Box 9).

Box 9 Consultation questions

Question (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?

Question (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 the business?

Question (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?

8.3 In addition to receiving responses to the Review’s consultation document that commented on these questions, the Review team also undertook a series of some 30 interviews with chairmen and non-executive directors of the largest life mutuals to understand more fully their individual perspectives on the non-executive role and the challenges they faced. The rest of this chapter sets out the key findings from these submissions and interviews and, drawing on these and research commissioned by the Review, sets out some principles that the Review believes should help the non-executives of life mutuals better define and execute their role.

¹ Chapter 20, paragraph 50

INFORMATION

8.4 Respondents report that the quality of information flowing to non-executives has improved markedly over the last three years. This of course has been heavily influenced by new FSA requirements in terms of the PPFM, realistic reporting and capital adequacy statements (described in more detail in Chapter 7). Intensifying competition in product markets has also, according to some interviewees, focused much more board attention on the profitability of new business. This has been accompanied, in the views of some longer serving non-executives, by a significant shift of emphasis from the longer-term to the shorter-term in regard to the sustainability of performance, risk exposures and capital adequacy.

8.5 Nevertheless, a number of interviewees readily acknowledged that until recently the quality of information going to non-executives in their own organisations had been 'very poor', with monthly reporting focusing too much on service standards and the performance of individual functions with no cohesive integrated profit focus. As one interviewee put it, "*this organisation was not run as a business but as a set of functions*". Others commented that extensive statistics were provided but until recently not enough in the way of performance measures that were clearly linked to the success of the business.

DEFINING SUCCESS IN A MUTUAL

8.6 Even though board-level information is now seen as far better directed to the needs of non-executives, an underlying problem is the difficulty of defining clearly what success means in a mutual context. Some non-executive board members with prior proprietary company board experience in particular drew attention to the fact that in a proprietary environment management failure could be much more readily identified because the corporate objective was typically much more clearly defined. By contrast, for life mutuals the attractiveness of taking on new business, whether with-profit or non-profit, had constantly to be reviewed in the light of the interests of existing members. Similarly, while members are naturally concerned about the financial performance of their products, in at least some life mutuals, especially those with a strong affinity base, the continued preservation of members' non-financial benefits is an important consideration for them and therefore for boards.

Implications for board composition

8.7 Against this background, non-executives in the major life mutuals have interpreted their role – in line with the recommendations of Sir Derek Higgs' "*Review of the Role and Effectiveness of Non-Executive Directors*"² and the Combined Code – as one of probing and challenging executive management with a particular emphasis on the need for this to be a team effort, with clear unity of purpose. To achieve this, boards have taken one of two approaches (as is discussed further in Chapter 9). The first has been to aim for a well-balanced portfolio of distinctive professional skills to be represented within the non-executive group. While no two boards face exactly the same set of needs, the professional disciplines typically represented have been actuarial, legal, accounting, and investment management. Other, less widely represented, non-executive specialist skill sets drawn upon in recent years have been in the areas of product marketing and information technology. The second approach to

² http://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf

board composition has focused by contrast on securing the services of individuals with broad general and financial management experience.

8.8 Whichever route is followed, the objective in each case has been to avoid what one chairman termed “*the risk of lopsidedness*”. On any issue, as he put it, “*the goal is to have a nucleus of non-executives who are on top of it*”.

Role of generalist non-executives

8.9 The role of non-executives is not, however, seen as a matter of second-guessing management but rather of asking the right questions with a degree of persistence, and following up assiduously on whether promised actions have been carried out.

8.10 Inevitably in such situations a specialist non-executive runs a risk of leaving fellow colleagues behind. Hence there is a need for such individuals to work hard to be understood in terms of the main substance of their concerns so that other board members can add their contribution from a non-technical standpoint. A non-executive director should not hide behind the complexity or technicality of a business as an excuse for failing to understand the crucial impact that such complex or technical issues might have on its viability. Here the governance requirement is to engage in sufficient questioning to ensure that a proper understanding of the issue emerges.

8.11 As one respondent commented:

“Generally, it (is) a sign of weak management to fail to put over an issue clearly. This is the case in any specific expertise (treasury, financial, actuarial or legal) and a good board or non-executive will see through it.”

Or, as another stated:

“...Although it is often difficult to challenge the executives about these technical elements, it is still true that, unless the executive can explain them in a way that intelligent non-specialists can understand, then a director should not be satisfied.”

This perspective was shared by Lord Penrose, who in his report into Equitable Life commented:

“In general it is the defining characteristic of an expert that he or she can communicate the results of his or her expertise with sufficient clarity to enable any reasonably intelligent person vested with a decision-making power effectively to exercise that power. Actuaries need not be in an exceptional position in this respect, and life offices’ boards can be as competent as others to reach decisions on the basis of intelligible advice.”

8.12 Others again pointed to the need in such circumstances for non-executive directors to be prepared to call upon external advice. While it is evident that such a step may be seen by executive management as potentially divisive and destructive of trust, this need not be the case provided that non-executive board members make it clear that the objective of such external advice is to understand fully the issues at stake, not to second-guess the proposals for which management seeks approval.

Skills of non-executives

8.13 For a number of the major life mutuals with strong affinity connections, a certain proportion of the board has traditionally been assigned to individuals from within the affinity group. This has the natural advantage of providing a degree of closeness to members' interests and concerns, an advantage that lies at the heart of the mutual proposition. The governance issue this raises, however, has been how to reconcile such desirable affinity links with the need to perform an effective non-executive role as an 'ordinary man of business', or even as some respondents argued, to meet the higher level test of demonstrating the skill and prudence of someone familiar with the specific demands of life insurance boards.

8.14 Two patterns of response emerged: first, the effort to ensure that any such individual board members take all the necessary steps in terms of induction and continuous professional development, especially in regard to the implications of new regulatory requirements, to equip them to play a full part as main board directors in ongoing boardroom discussions; secondly, the redesign of governance arrangements so that individuals who previously held main board director responsibilities step across to advisory panel positions and are not therefore required to be approved by the FSA.

8.15 The Review does not believe that one approach is necessarily better than the other, but would emphasise that under any circumstances those making appointments to the board should satisfy themselves that all individuals appointed to the board should have the requisite attributes and abilities to be a capable non-executive. If individuals of the right calibre are not to be found from among the society's membership, the alternative approach should be considered.

Director development

8.16 Regardless of whether they have affinity connections, life mutual non-executives generally accept the need for ongoing professional training. Some of those with proprietary board familiarity particularly miss the input of an external analytic community, and the strong body of independent opinion that results from this – a source of input helpful to the independent board member.

8.17 Others pointed to the benefit of the disciplined external appraisal process of the rating agencies, although this only covers a relatively small number of life mutual firms. Some board members also expressed the view that their monitoring and scrutiny task was being assisted by the greater transparency of reporting now required. This was seen as increasing the real visibility of their organisation's performance in the marketplace and enabling better external assessment by IFAs and the financial press, thereby indirectly alerting non-executives to potentially material issues for board discussion.

8.18 In addition to all these sources of input to the non-executives, there is also the potential role of the FSA, which has already been discussed in Chapter 7. While the natural focus of dialogue here will remain between executive management and the regulator, there is value in building on the current practice of supplementing this dialogue with meetings between FSA and non-executive board members. In addition to helping better inform non-executives by providing a forum for the FSA to communicate to them issues – either generic or firm specific – of current regulatory concern, such a dialogue would serve as an opportunity for the regulator to test non-executives' awareness of key issues. As such this dialogue could be expected to enhance regulatory scrutiny through promoting good governance.

8.19 This could be, as one respondent suggested, in the form of a formal annual meeting without the presence of the executive for a general discussion of any outstanding issues and concerns. Alternatively, it could take the form of a more wide ranging exchange of views on industry wide challenges, and involve the participation of a number of non-executives from different companies.

Encouraging debate

8.20 Alongside measures to equip non-executives to deal with complex or technical questions through a combination of better skills within the board and greater access to specialist expertise, a number of respondents and interviewees emphasised a different dimension of the monitoring process: the need to be satisfied at all times of the capability of management. This requires establishing confidence in the good faith of the executive team together with an astute feel for their competence, individual by individual. Apart from formal personnel reviews of the senior executives, many interviewees felt that the real key to developing this confidence lay in the robustness of boardroom debate. Traditionally, some felt, life mutual boards had simply been too polite an environment. As one non-executive expressed it:

“...to ask the good question you often have to be prepared to ask a number of bad ones. The right question only emerges slowly”.

What can members expect of non-executives?

8.21 In light of these considerations, it is important that members of life mutuals should have realistic expectations of their non-executive directors. The task of coping with complex or technical issues at board level is capable of being handled effectively through a combination of measures. These include a thoroughly professional nominations process to identify appropriate candidates in terms of skill and character; a well-designed induction and continuous professional development programme; periodic board and individual director assessment, and the adoption of the framework of board architecture and processes, including sub-committee work that is set out in the Combined Code.

8.22 Even with these elements in place, however, the nature of the typical non-executive time commitment to board related work is normally – apart from a crisis – no more than 20 to 25 days a year. So mutual member expectations need to be geared to the realities of what individual board members, however committed and diligent, can accomplish practically within that timeframe.

8.23 In a complex and technical business such as life insurance this requires a board to take a particularly disciplined approach to delegation. In this environment the role of the board is governance not management. In turn this implies that delegation takes place in a principled way, with a clear purpose, ideally to a chief executive as the single accountable executive (though not the only executive director), who can in turn delegate more specific management responsibilities. Such delegation however is only consistent with the preservation of full board accountability and fiduciary responsibility to members if it is combined with a clear statement defining the boundaries or limits of management’s discretion, and if this is then linked to a robust chain of reporting. This then enables management to be held to account for its performance against well-defined and agreed policy objectives set by the board. At the same time, it leaves management with the necessary entrepreneurial scope to be innovative and open to change.

Corporate purpose

8.24 The most crucial component of the governance process for a life mutual, however, is the determination of the overarching corporate purpose – what the entity exists to do. For most proprietary companies this is an entirely straightforward matter, typically expressed with reference to shareholder value maximisation with regard to the interests of other stakeholders. The board of a life mutual, by contrast, has a fundamentally more complex task. It needs to balance the interests of different categories of existing members, by product type and by cohort, not only against the interests of potential future members, but also the interests of policyholders who may not be members, as well as, of course, still having regard to other stakeholders such as employees. Issues of particular concern to non-executive directors include, for example, the need to scrutinise carefully the circumstances under which it makes sense for management to write loss-making new business, and the importance of monitoring the implications of a declining with-profits membership base.

8.25 The need to be clear about corporate purpose is an essential element in the corporate governance framework for life mutuals in the UK. In light of changing market conditions many of these individual companies have in recent years carried out major shifts in their customer focus, their related product range, and their distribution approaches. Against this context, it is an important governance task to ensure that the current body of members is kept informed of this progressive transformation and its impact, over time, on their mutual membership.

CONCLUSIONS

8.26 Looking ahead, therefore, the Review believes that, in addition to the value to be derived from formal adherence to the Combined Code, the governance of life mutuals is likely to be further strengthened by careful attention to the need for clear definition of corporate purpose, supported by well-defined principles of delegation from the board to management that are accompanied by strong monitoring and reporting processes and clear policy boundaries that set limits within which executive management has entrepreneurial freedom to act and innovate.

8.27 Many life mutual boards have made progress in this direction. But the Review believes it would be appropriate for life mutual boards to ensure that their own members understand the governance policy framework that they are working within, so that there is much greater understanding of the respective roles of the board and of executive management. To this end, a public statement setting out in reasonable detail the nature of such a governance framework would be a helpful step, with additional benefit to other constituencies such as non-member policyholders, IFAs, and the financial media.

8.28 Finally, to draw together the issues discussed in this chapter, the Review would like to suggest the list of principles in Box 10. They are aimed at helping the non-executives of life mutuals better to define and execute their role.

Box 10 Life mutual governance: principles for non-executives

1. Ensure that the board as a whole agrees and carefully articulates a definition of corporate purpose that will best serve the interests of members and correspondingly define the longer-term performance objectives for the chief executive and management.
2. Clearly distinguish the governance responsibilities of the board from the management responsibilities of the chief executive and his or her team. This requires defining the scope and level of detail of the board's policy setting role and the basis on which it delegates authority.
3. Ensure that disciplined processes of delegation – with clear purpose and clear limitations – are put in place so that the board is able to hold the chief executive fully accountable.
4. Maintain board accountability and fiduciary responsibility to members through monitoring the performance of the chief executive and the management team against clearly specified criteria, agreed in advance, that contribute to the fulfilment of the corporate purpose.
5. Insist that information designed for the board is efficiently focused on issues relating to performance against agreed operating and strategic objectives and that policy issues requiring board decision or guidance are fully explained.
6. Where insufficient interpretation of complex issues is provided in advance of board meetings or is achieved in the course of board discussion, ensure that a culture of 'relentless questioning' becomes the norm, with additional staff support to the board being called upon where necessary.
7. Fully commit to the board performance review process to ensure that the board's own working practices and individual director effectiveness are kept under regular scrutiny.
8. Take active steps to communicate to members and other policyholders the governance framework and the practicalities of how the board operates. This should be done on an annual basis, using the AGM and annual reports, supplemented as appropriate by website information and member forums.

9

THE EFFECTIVE BOARD

9.1 The original version of the *Combined Code for Corporate Governance* was produced by the Hampel Committee in June 1998. An updated version was published by the FRC in July 2003. The changes in the 2003 version derived from the review of the role and effectiveness of non-executive directors by Sir Derek Higgs and a review of audit committees by a group led by Sir Robert Smith. It now also includes the guidance on internal control produced by the working party chaired by Nigel Turnbull¹.

9.2 The Combined Code is annexed to Section 12.43A of the UK Listing Authority (UKLA) Listing Rules². 12.43A requires listed firms to ‘comply or explain’ – in other words, to make in the Annual Report a narrative statement of how the principles in the Combined Code have been applied and a statement of compliance including reasons for non-compliance. Although some life mutuals have listed debt securities, Section 9.46 of the Listing Rules states that 12.43A does not apply to such firms, as opposed to those with an equity listing.

9.3 Although the Combined Code has been developed primarily in the context of listed companies, the Review believes that it is a source of generally relevant principles and best practice for corporate governance in the UK, including for life mutuals. As Sir Derek Higgs put matters in his response to the Review’s consultation:

“Much of the Combined Code addresses practical behavioural issues stemming from the important principles of separation of function, independence and transparency. As such, a significant proportion of it is of relevance more widely than just to the listed company sector, including to mutual life offices.”

9.4 This chapter considers what adjustments, if any, might be needed for the Code to be applied in this sector and how adherence to such a Code could be promoted, including the role of the FSA. It also explores a number of the key governance issues in the context of the principles and provisions of the Code, in particular board balance and independence, board structure and committees, skills, professional development, appraisals, support for non-executive directors and directors’ remuneration.

Current status of the Combined Code and life mutuals

9.5 As paragraph 9.2 explains, adherence to the Combined Code is not mandatory for any life mutuals although several state in their annual reports that they already comply with the Combined Code to the extent that it is relevant. The survey evidence discussed in Chapter 4 also suggests that some life mutuals adhere quite closely to the Code, as do many other financial mutuals, for example building societies. The BSA has recently published an annotated version³ of the July 2003 Combined Code for its members.

¹ ‘Internal Control: Guidance for Directors on the Combined Code’: http://www.icaew.co.uk/cbp/index.cfm?aub=tb21_6242

² The relevant part of Rule 12.43A is in Box 11.

³ <http://www.bsa.org.uk/Information/IndustryPDFs/6033270904.pdf>

9.6 It is clear, moreover, that the Code is already something of which all life firms should be aware. The FSA's Interim Prudential Sourcebook for Insurers (IPRU(INS)) contains guidance on corporate governance for insurers that points to the Code as a source of best-practice guidance. FSA's Risk Assessment Framework⁴ also identifies corporate governance as one of the elements that it will consider in its assessment of firms. It mentions a number of specific issues such as board balance and committee structure that are considered in the Combined Code and includes a specific reference to adherence to the Code for listed firms.

9.7 It is not surprising, therefore, that the overwhelming majority of respondents to the Review's consultation document, in answer to the question "*To what extent does the current guidance on corporate governance, particularly the Combined Code, provide an appropriate framework for mutual life offices?*" expressed the view that the Code was indeed the place to start.

Tailoring the Combined Code for life mutuals

9.8 Moving beyond the issue of the fundamental relevance of the Combined Code to life mutuals, this section considers whether the Code might be either adopted 'as is', or adapted to reflect the particular attributes of life mutuals, or instead used as a source for a new, stand-alone best practice code for life mutuals.

9.9 The opinions of consultation respondents were again largely in favour (approximately 2:1) of tailoring the Code in some way to reflect the particular attributes of life mutuals as opposed to relying on the Code without either modification or additional guidance. Only a small number of respondents suggested that it would be better to produce a bespoke code of practice for life mutuals instead of, for example, annotating the existing Code to offer guidance on its application (the latter being the approach that the BSA has taken in producing a version of the Code for its members).

9.10 The Review has concluded that developing an entirely separate code for life mutuals is unnecessary and not in the best interests of the sector. Guidance that is rooted firmly in the Combined Code would allow life mutuals to benefit from current best practice as well as future development of the Code. Otherwise there would be a risk that in time the life mutuals' version of the Code and the Combined Code would diverge.

9.11 The Review recommends, therefore, that life mutuals should adhere to a version of the Combined Code that is appropriately tailored. This should take the form of a copy of the Code, itself wholly intact, annotated with guidance that does not alter the principles of the Code but aims rather to promote interpretations that best uphold these principles in this sector. Annex D contains a draft annotated Code. The Review calls upon the AMI and the AFS to consult with their members on the draft annotations in Annex D with a view to agreeing a final version for adoption for the beginning of the financial year 2005-06. The Review would thereafter wish to see the AMI and the AFS collect and publish annually information on adherence to key aspects of the Code. It is recommended, furthermore, that the Treasury conduct a review of compliance by life mutuals with the annotated Code early in 2008, following the publication of annual reports for the financial year 2006-07.

⁴ http://www.fsa.gov.uk/pubs/policy/bnr_firm-framework.pdf

Recommendation 3

Life mutuals should adhere to a version of the Combined Code that has been annotated with guidance that does not alter the principles of the Code but aims rather to promote interpretations that best uphold these principles in this sector.

The AMI and the AFS should consult with their members on the draft annotations in Annex D with a view to agreeing a final version for adoption for the beginning of the financial year 2005-06.

The AMI and the AFS should collect and publish annually information on adherence to key aspects of the Code.

The Treasury should conduct a review of compliance by life mutuals with the annotated Code in early 2008, following the publication of annual reports for the financial year 2006-07.

9.12 The Review also notes that the FRC is intending periodically to review⁵ the Combined Code. The AMI and the AFS should, therefore, ensure that the annotations to the Code for life mutuals are updated after each such review to ensure that they remain in step with changes in corporate governance best practice.

Recommendation 4

The AMI and the AFS should ensure that the annotations to the Code for life mutuals are updated when the Combined Code itself has been reviewed.

Promoting adherence to the annotated Combined Code

9.13 As noted in paragraph 9.2, adherence to the Combined Code by listed companies is on a 'comply or explain' basis. The Review's consultation document raised the question of how "*the principle of 'comply or explain' in the Combined Code – which assumes an ongoing dialogue between the company and its shareholders – might need to be re-considered in the mutual context*". A majority of respondents to the consultation who expressed a view thought that adherence to the Combined Code (tailored or otherwise) by life mutuals should somehow be made compulsory. Of these, more than four-fifths thought that this should be through the action of the FSA, in which case a number of alternatives present themselves:

- A rule equivalent to 12.43A could be introduced into the FSA's forthcoming Integrated Prudential Sourcebook so as to require firms to 'comply or explain';
- As above but with the stipulation that the FSA would be the counterparty to the process of explanation of departures from the Code;
- That a rule could be introduced requiring life mutuals to comply without the option of an explanation of departures from the Code being an alternative mode of compliance (in effect 'comply or else').

⁵ See <http://www.asb.org.uk/press/pub0583.html>

9.14 The Review does not, however, consider that any of these options would be an appropriate course of action. If any such rule were introduced, either it would have to apply to all firms (and the Review would have to be convinced that there were no viable alternative courses of action open to it as this goes considerably beyond its terms of reference), or the FSA would need to be able to justify why it had decided to impose requirements on a narrow group of the firms it supervised, in this case life mutuals. The Review understands that the FSA has concerns about making rules for a specific sector on the grounds that this runs contrary to the rationale of having a single regulator and the aim achieving greater consistency across the financial sector. More importantly, it is also likely that the second and third options above would amount to making the FSA a ‘governance regulator’ (as opposed to the current situation whereby it is a regulator that will consider governance of regulated firms when this is relevant to its statutory objectives). This would not appear to be compatible with the FSA’s current functions under the FSMA.

9.15 The Review finds the third option particularly unattractive, as it would seriously undermine the operation of the principle of ‘comply or explain’ in sectors beyond the scope of this Review. This is a vital source of flexibility in the operation of the Combined Code that allows firms – be they proprietary or mutual – to adhere to the principles of the Code in a manner that best reflects their individual circumstances.

9.16 This does not mean, however, that the FSA has no interest in adherence by life mutuals to the annotated Combined Code. FSA guidance already makes reference to the Combined Code (see paragraph 9.6 above). This, and the attention paid to governance in the risk assessment process, led a number of respondents to the consultation (including a number of life mutuals) to observe that, in effect, they already enforced the Code for all firms, listed or not.

9.17 The Review believes that life mutuals should adhere to the Code on a ‘comply or explain’ basis. A governance statement in the Annual Report of the form described in 12.43A of the Listing Rules (shown in Box 11) should be seen by all firms as an essential part of this process. Moreover, though this disclosure plays an important part in ensuring that a firm is accountable to its members on governance matters, it alone may not be sufficient. It may be appropriate, for example, to discuss governance arrangements directly with member representatives as part of the dialogue discussed in the annotations to section D.1 of the draft Code in Annex D. Firms should also anticipate that the FSA would wish to discuss compliance and their explanations for departures from the provisions of the Code in the context of a risk assessment or other supervisory work.

9.18 The FSA has, therefore, been consulted about the development of the annotated Combined Code for life mutuals and has welcomed this initiative. The FSA expects that such guidance will be helpful in identifying the issues to be considered by life mutual boards when seeking to apply the latest version of the Combined Code to the different circumstances of a life mutual and to their particular firm.

9.19 Some of the draft annotations to the Code suggest alternative approaches to those set out in the text of the Combined Code itself. The FSA awaits the outcome of the consultation by the AMI and the AFS with their members on the draft. However, it has said it shares the Review's objective that, by following such guidance in the annotations, firms should be able to demonstrate that they have had regard to FSA's own high-level guidance relating to corporate governance.⁶ The Review recommends, therefore, that the AMI and the AFS should consult the FSA on this point in respect of the version of the annotated Code that they adopt for implementation by their members. The consultation will also need to seek views from the FRC on any changes to the annotations to avoid any unintended consequences for the Code as it applies to listed companies.

9.20 The Review hopes that the annotated Code will be a useful reference point for the FSA in its day-to-day supervision of individual life mutuals. In addition, the Review feels that it will be important for FSA to look in the round at the extent to which the Code is adopted across the sector. In particular, it would be important for the FSA to understand firms' reasons for not adopting the annotated Code as a model for governance, or for choosing to explain rather than comply with a particular provision of the Code, in order to understand whether there are any generic regulatory issues that may need to be addressed. The Review is pleased to note that the FSA has agreed to look at these issues in 2008, by which time the Code should be well established in the sector.

Recommendation 5

Life mutuals should adhere to the annotated Code on a 'comply or explain' basis. A governance statement in the Annual Report of the form described in 12.43A of the Listing Rules should be seen by all firms as an essential part of this process.

It may be appropriate to discuss governance arrangements directly with member representatives. Firms should also anticipate that the FSA would wish to discuss compliance and their explanations for departures from the provisions of the Code in the context of a risk assessment or other supervisory work.

In the taking forward the consultation on the annotated Code, the AMI and the AFS should be mindful of the objective, shared by the Review and the FSA, that by following such guidance in the annotations, firms should be able to demonstrate that they have had regard to FSA's own high-level guidance relating to corporate governance.

The FSA is to take forward, in 2008, work to understand firms' reasons for not adopting the annotated Code as a model for governance, or for choosing to explain rather than comply with a particular provision of the Code, in order to understand whether there are any generic regulatory issues that may need to be addressed.

⁶ Including, for example IPRU(INS) Guidance Note P.3, paragraph A3 "In managing its affairs, a firm should have regard to such generally accepted principles of good corporate governance (including the Combined Code on Corporate Governance where appropriate) as it is reasonable to regard as applicable to it."

Box 11 From Rule 12.43A in the UKLA Listing Rules

Corporate governance

12.43A: In the case of a company incorporated in the United Kingdom, the following additional items must be included in its annual report and accounts:

- (a) A narrative statement of how it has applied the principles set out in Section I of the Combined Code, providing explanation which enables its shareholders to evaluate how the principles have been applied;
- (b) A statement as to whether or not it has complied throughout the accounting period with the Code provisions set out in Section I of the Combined Code. A company that has not complied with the Code provisions, or complied with only some of the Code provisions or (in the case of provisions whose requirements are of a continuing nature) complied for only part of an accounting period, must specify the Code provisions with which it has not complied, and (where relevant) for what part of the period such non-compliance continued, and give reasons for any non-compliance.

The role of the external auditor

9.21 The Listing Rules, in the section entitled *‘Requirements of auditors’* at the end of 12.43A, also require the external auditor to review the company’s statement with regard to those sections of the Code relating to Accountability and Audit (Code provisions C1.1, C.2.1, C3.1, C3.2, C3.3, C3.4, C3.5, C3.6 and C.3.7). The UKLA rule on this subject has recently been updated to take account of the revised (2003) version of the Code⁷. The Review recommends that this review by the auditor should be regarded as best practice by life mutuals.

Recommendation 6

Life mutuals should require the external auditor to review the company’s statement with regard to Code provisions C1.1, C.2.1, C3.1, C3.2, C3.3, C3.4, C3.5, C3.6 as described in listing rule 12.43A Requirements of the auditor.

9.22 The FSA (in its role as the UKLA) consulted on whether the auditor should, in addition to the above, be required to review all of the objectively verifiable Code provisions, or even to consider whether *“the directors’ Comply or Explain statement has been made after ‘due and careful enquiry’*”. A small number of respondents to the consultation suggested that the auditor should be required to take this role in life mutuals. The Review feels, however, that this would not be appropriate as there is a risk that the auditors’ report would create an ‘expectation gap’: it would be assumed that the auditors have approved the explanations and confirmed the effectiveness of the governance of the firm rather than just certifying the factual content or the process followed by directors in compiling the report.

⁷ See http://www.fsa.gov.uk/pubs/cp/cp04_08.pdf and http://www.fsa.gov.uk/handbook/legal_instruments/2004/2004_83.pdf

Small firms

9.23 A number of respondents to the consultation expressed concern that standards of governance may be low in small mutuals. A few members of small friendly societies (including committee members) also expressed reservations about particular aspects of governance in their societies.

9.24 The Review accepts that issues of cost will have a bearing on what can be expected in governance terms from the smallest firms in the sector. As the FSA put in its response to the consultation:

“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 lower calibre than for a large firm).”

Nevertheless, as noted by Sir Derek Higgs, and quoted in paragraph 9.3, the governance principles of the Code are applicable to all. Indeed the AFS stated in its response to the consultation document⁸ that:

“We [...] do not believe that the principles of governance are inherently different according to size or customer base.”

9.25 The Review intends, therefore, that the annotated Code should apply to all of the forms of mutual undertaking engaged in life insurance business in the UK, including small friendly societies. The flexibility inherent in the principle of ‘comply or explain’ should enable any firm to achieve a manner of adherence appropriate to its circumstances, taking into account its size, legal form and the Rules of the society or the Articles of Association of the company.

9.26 Cost is a very real issue in some areas but should not be used as a blanket excuse for failure to have good governance. The Review feels that it would be helpful for the AFS, working with the AMI, to produce more detailed guidance on the interpretation and application of the annotated Combined Code for small friendly societies. The FSA and the FRC should be invited to comment on this guidance in draft.

9.27 The Review also recommends that the FSA pays due attention to small firms when it undertakes the work described in recommendation 5.

Recommendation 7

The AFS, working with the AMI, should produce more detailed guidance on the interpretation and application of the annotated Combined Code for small friendly societies.

The FSA should pay due attention to small firms when it undertakes the work described in recommendation 5.

⁸ Question 15 “Do small, affinity group-based, mutual life firms face different governance issues from the largest firms in the sector?”

AN ANNOTATED COMBINED CODE FOR LIFE MUTUALS

9.28 The remainder of this chapter explains the Review's thinking on Combined Code topics that have informed the annotations to the Code given in Annex D. It draws upon information from the governance survey described in Chapter 4 and the discussion in Chapter 5 of the governance issues facing life mutuals. A number of points raised in the course of the consultation conducted by the Review are also discussed. The aim throughout is to consider how best to ensure that life mutuals have well-functioning, balanced and effective boards that can deal with the complexities of the life assurance business.

Board balance and independent directors

9.29 The analysis in Chapter 5 stresses the importance of internal checks and balances in a life mutual. This is in recognition of the lack of external monitoring from large shareholders, the lack of a market in corporate control and the difficulties faced by members in holding management to account. The most important source of internal challenge is that provided by non-executive directors (and as noted earlier in this chapter preferably ones who meet the Code definition of independence). The Combined Code (A.3.2) recommends that at least half the board, excluding the Chairman, should comprise non-executive directors determined by the board to be independent. A.3.1 describes how independence might be judged. The survey data described in Chapter 4 indicate that most life mutuals do not have a clear majority of independent non-executives. This is a matter of some concern given the weakness of other checks and balances. The Review would wish any boards not meeting this goal to explain carefully in their governance report why this is the case.

9.30 A point raised by some consultation respondents was that the complexity of life assurance meant experienced non-executive directors were particularly valuable. It was suggested that it would be beneficial if life mutuals could be allowed to retain non-executives longer than the nine years regarded in the Combined Code (A.3.1) as the normal time limit for independent tenure. The Review realises that boards face a difficult issue, reconciling the difficulty of finding good non-executive directors – and the desire not to lose them – with the need to ensure that the board has an appropriate number of independent directors and that the “*planned and progressive refreshing of the board*”⁹ takes place. The Combined Code independence test should not be taken to mean that under no circumstances could non-executive directors serve for longer than nine years, rather that under such circumstances they would not normally be regarded as independent. If firms believe that any long-serving non-executives remain independent, they would need to give an explanation as to why.

Board Structure and Committees

9.31 Some respondents to the Review's consultation suggested that the need in a life mutual for strong internal monitoring of the executive by the non-executives would be best met by having a separate supervisory board composed of non-executives only. Others proposed that the mutual form has inherent capital and strategic constraints such that management has less discretion than in a proprietary firm and can be held to account properly and efficiently with a two-tier system. The Review has, therefore, given some consideration as to the most appropriate structure of the board in life mutuals.

⁹ From Combined Code main principle A.7

9.32 Critics of two-tier boards generally claim that the supervisory board tends to become remote from the business, that the overall structure is too rigid and that slow decision-making is the result. Set against that are the potential benefits for life mutuals of clear separation of the supervisory and the management roles to achieve additional focus on the former. At the same time, the complexity of the life assurance business might argue against increasing the separation between executive and supervisory functions.

9.33 The UK laws governing the formation of economic undertakings (for example the Companies Acts) do not allow firms to take a true supervisory board structure, as is found in other European countries, in which the supervisory and management boards (or the directors on these boards) have distinct legal responsibilities. It is clear, however, from the arrangements adopted in a number of UK firms (both proprietary and mutual) that the current legal framework, while requiring that all directors have the same legal duties, is extremely flexible. It allows firms to organise the board's activities in ways that are distinct from a pure unitary model and might be described as a hybrid. Indeed board committees such as the audit committee, which should be composed of independent non-executives only, already give most boards an element of tiering in an organisational if not a legal sense.

9.34 The Bullock Report on Industrial Democracy¹⁰ noted the flexibility of the UK system:

"In practice the distinction between a one-tier and a two-tier system is blurred and there are senses in which many United Kingdom companies have developed a de facto two-tier system...The distinguishing feature of a statutory two-tier system is that the law establishes two levels of control in companies...and defines in detail the functions of each."

9.35 The Report reached the view that a two-tier structure should not be introduced into the UK:

"The evidence suggests, therefore, that the distinction between a supervisory and a management board is a difficult one to maintain in practice since the effective fulfilment of either role demands close involvement in the other."

"The effect of the introduction of a statutory two-tier system in this country could be to enshrine in the law the dominance of management to the detriment of the interests of both employees and shareholders."

9.36 While there is value for life mutuals from clear delineation of supervisory and management roles, the Review concludes that, given the flexibility inherent in the present UK system, it would be neither necessary nor appropriate to require life mutuals to adopt two-tier board structures. As long as there is absolute clarity over the role of the board and the scope of the delegation of responsibility from the board to management (as is discussed in Chapter 8), with appropriately constituted committees of independent directors to address specific areas that are not appropriate for delegation to the executive (for example with regard to the audit, directors' remuneration, and board nominations), it should be possible to achieve a suitable level of segregation of duties without requiring a supervisory board structure.

¹⁰ "Report of the Committee of Inquiry on Industrial Democracy", Department of Trade, 1977, Cmnd. 6706

9.37 In this context, an area that requires special focus in life mutuals is risk management. This should be a matter for the audit committee or a separate risk committee (both approaches are compatible with the Combined Code). In either case, the Turnbull guidance on internal control, which is attached to the Combined Code (see paragraph 9.1), is of key importance.

Skills

9.38 Consultation respondents' views were divided as to whether they thought specialist or generalist non-executives most valuable to life mutual boards. A third of respondents suggested that the complexities of the life industry meant that specialist qualifications were more important than generalist business backgrounds. Of these respondents, nearly half specifically advocated that at least one non-executive director should have actuarial qualifications. On the other hand, nearly half of consultation respondents who addressed the issue of board composition commented that the key skills for non-executive directors are independence and a willingness to challenge, and that the ability of generalists to deal with technical issues can be addressed through training and access to relevant, good quality advice. Around one fifth favoured neither specialists nor generalists but advocated a mix of both, as appropriate to the size and complexity of the business.

9.39 As discussed in Chapter 8, the Review does not favour a prescriptive approach in this area. Boards and nominations committees may well wish to consider whether actuarial experience would be valuable amongst the non-executives but the Review does not wish to recommend that all boards of life mutuals should seek to have a qualified actuary among the non-executive directors. Such qualifications can be valuable but they are not the only attributes needed of an effective non-executive director.

Independent actuarial advice

9.40 It is relevant to note in this context that the FSA's recent with-profits review (discussed in Chapter 7) and other reforms of the regulatory regime for insurers have brought about significant changes to the provision of actuarial advice to the board and the independent scrutiny of the actuarial advice generated within the company. The Morris Review of the Actuarial Profession¹¹ is considering whether the role of the reviewing actuary (see Box 5 in Chapter 7 for a description) should be expanded to include consideration of a wider range of actuarial issues. The Review would regard an increase in independent scrutiny of actuarial advice as a help to boards in fulfilling their fiduciary duty. This does not mean, however, that non-executive directors will not need to be familiar with actuarial concepts or that nominations committees no longer need to consider whether professional actuarial experience would be a useful attribute for one or more of their non-executive directors.

9.41 Although the Review does not wish to prescribe the skills or qualifications that board members should have, it recommends that the annual report of a life mutual should contain a description of each director's expertise and experience (including the date of appointment to the board, previous roles in the firm, relevant qualifications and experience, other directorships held by the individual, and brief details of previous employment including positions held and responsibilities). Alongside this in the annual report, the board should make a clear statement about its own balance, completeness and appropriateness to the requirements of the business. Both this and the description

¹¹ See http://www.hm-treasury.gov.uk/independent_reviews/morris_review/review_morris_index.cfm

of directors' details should also be available on the firm's website. The Review would encourage any firm that does not already have a website to establish one.

Recommendation 8

The annual report of a life mutual should contain a description of each director's expertise and experience. Alongside this in the annual report, the board should make a clear statement about its own balance, completeness and appropriateness to the requirements of the business. Both statements should also be available on the firm's website.

Induction and professional development

9.42 The discussion of actuarial matters in the previous section highlights the complexity of issues facing life mutual non-executives, a topic also explored in Chapter 8. Given the vital monitoring role played by the non-executive directors in a life mutual, it is essential that they all receive adequate induction when they join the firm and continuing professional development throughout their tenure. This should cover appropriate actuarial matters for all boards, including those with non-executives that have actuarial experience amongst the non-executives.

9.43 The Review recommends, therefore, that the AMI and the AFS, in consultation with the FSA, the IoD and the ICSA should develop an induction and professional development programme for non-executive directors of life mutuals, to include both technical and governance issues.

Recommendation 9

The AMI and the AFS, in consultation with the FSA, the IoD and ICSA should develop an induction and professional development programme for non-executive directors of life mutuals.

Appointments to the Board

9.44 The board appointments process was a concern for consultation respondents not only in terms of the securing directors with the right character, skills and experience but also as regards the appointment process itself – the need for the board to avoid being, in the words of Lord Penrose, a “*self-perpetuating oligarchy*”.

9.45 The guidance in section A.4 of the Combined Code for ensuring a “*formal, rigorous and transparent procedure for the appointment of new directors to the board*”, and the ‘Summary of the Principal Duties of the Nomination Committee’ in the Higgs guidance annexed to the Code are, therefore, particularly important. The problems of external monitoring in life mutuals suggest that the recruitment process should involve appropriate sources of objective external opinion. When seeking to appoint non-executive directors, as well as considering the use of external recruitment consultants to lead the process, the nominations committee may wish to seek other outside views, for example by involving member panels. Where consultants are appointed, it would be appropriate to make available a statement as to whether they have any other connection with the company and describing in some detail the services provided and the process followed. The advertising of posts may also be considered as a way of reducing the reliance on the personal connections of existing board members.

Recommendation 10

Appointments to the board should involve appropriate sources of objective external opinion, which may include considering using external recruitment consultants and seeking the views of member panels.

Board performance evaluation

9.46 One of the principles of the Combined Code (A.6) is that “*the board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors*”. The need for this is evident in life mutuals, given the relative weakness of external monitoring of life mutual boards, and a number of companies have already taken steps to introduce such a process.

9.47 The Higgs suggestions for good practice, which are annexed to the Combined Code, contain a section entitled ‘Performance Evaluation Guidance’. This discusses the aims of the process, offers suggestions as to how it might be conducted and includes sample questions that should be considered. Of particular relevance to the circumstances of life mutuals are the suggestions firstly that the use of an external third party to conduct the evaluation will bring objectivity to the process; and secondly that the board should state in the annual report how such performance evaluation has been conducted.

9.48 Evaluating the quality of board performance in a life mutual is not simply a matter of assessing the effectiveness of individual director contributions and commitment, together with an appraisal of how well the board works together. More fundamentally, the annual evaluation provides an important opportunity to reconsider how well the governance framework as a whole is meeting its objectives. Foremost among these is the need to ensure continued clarity on the overarching corporate purpose – what the company exists to do. As discussed earlier (Chapter 8), this is not always a straightforward task for life mutuals, given the need to balance different interests. But unless there is clear agreement on this purpose it is hard to evaluate the effectiveness of the board in providing guidance and direction to management on corporate goals and performance targets.

9.49 Similarly, the annual board review is a good occasion to review whether the board is striking the right balance between a focus on broad questions of policy and involvement in matters of detail. As Sir Adrian Cadbury has said,¹²

“Governance is a separate function in its own right and is not a higher level of management. Governance sets the framework within which whatever is being governed can be managed. Good governance does not involve emasculating management.”

9.50 Correspondingly, a worthwhile board evaluation process will periodically consider how well the process of delegation is working and how effectively this is being matched by the quality and appropriateness of reporting processes back to the board. Only by defining carefully and realistically the policy guidance role of the board is it practical for non-executive directors of life mutuals to focus their time wisely and avoid being overwhelmed by the sheer volume of management information that may otherwise be sent to them.

¹² Foreword to Carver and Oliver, ‘Corporate Boards That Create Value’ Jossey-Bass, 2002.

Recommendation 11

A rigorous board appraisal should be conducted annually in all life mutuals. This should cover not only the performance of individual directors but also that of the board as a whole.

Information and support for independent directors

9.51 The Review feels that if board meetings are to feature an appropriate level of constructive challenge, certain facilities must be granted to non-executives. First, the chairman and the company secretary should ensure that issues non-executives wish to be discussed are placed on the agenda. Secondly, non-executives should receive the information and pro-active support that they require so that an informed discussion can take place. This should include allowing access to advice from independent sources when it is required.

9.52 The aim here is not that this should be divisive. The intention is to enhance the quality of the dialogue between non-executives and executives. Chapter 8 discussed the views of life mutual non-executives as to the quality of the information they receive and the impact it has on boardroom debate. The Review would wish this improvement to continue and for the result to be robust, informed and constructive discussion among executive and non-executive directors.

Independent advice

9.53 All respondents to the consultation who commented on the issue agreed that allowing non-executive directors access to advice from sources outside the company was important to enable them to exercise effective oversight of the executive. Section A.5 of the Combined Code states clearly that all directors, especially non-executives, should have access to independent professional advice at the company's expense. The survey data discussed in Chapter 4 indicate, however, that while allowing such access is standard practice in some firms, this is not the case in others.

9.54 Boards should establish clear procedures through which non-executives can obtain advice from independent external advisers at the company's expense when they "*judge it necessary to discharge their responsibilities as directors*"¹³. The availability of independent sources of advice should be made clear at the time of appointment (using, for example, the draft non-executive's letter of appointment in the Higgs best-practice guidance appended to the Combined Code in which a commitment to allow access to external advice is made). The website of the ICSA also gives a sample board motion to establish the availability of this facility¹⁴.

9.55 Non-executives need not seek to appoint a relevant adviser for each and every subject area that comes before the board. When difficult issues arise, the first course of action should always be to encourage further and deeper analysis to be carried out within the firm. Any board that finds it is routinely having to ask for external advice might be obliged to conclude either that something is wrong with the information flows to the board or with its procedures for seeking independent advice. But it is important that any non-executive can receive a second opinion at the firm's expense from a source that is independent of the executive when there is an important issue on which he or she does not feel comfortable despite having sought clarification from within the firm.

¹³ Combined Code provision A.5.2.

¹⁴ The ICSA model resolution on independent advice is at <http://www.icsa.org.uk/news/guidance.php>

Recommendation 12

The chairman and the company secretary should ensure that issues non-executives wish to be discussed are placed on the agenda.

Non-executives should receive the information and pro-active support that they require so that an informed discussion can take place.

When difficult issues arise, the first course of action should always be to encourage further and deeper analysis to be carried out within the firm but boards should establish clear procedures through which non-executives can obtain advice from independent external advisers at the company's expense when they "judge it necessary to discharge their responsibilities as directors".

Support for non-executives

9.56 While calling upon independent professional advice may from time to time be appropriate, it is also desirable that such non-executives should be able to draw readily on more permanent support to the board from within the company. The aim is to enable the non-executives to fulfil their role on the board effectively and to make efficient use of the limited time available to them in the company. In very large firms there might be scope for non-executives to have their own permanent support staff; in small firms a single nominated individual might take on this role along with other duties. Those giving support need to be pro-active.

9.57 In most cases the company/society secretary or a member of the company secretary's team is naturally best placed to lead in the support of the non-executive directors, given the privileged perspective on the work of the board that such individuals possess. This, the Review believes, is very much in line with the description of the role of the company secretary given in the Higgs report¹⁵ and in existing best practice guidance for company secretaries.¹⁶

9.58 It is important to recognise, however, that an expansion of board support in this way may well require some redesign of the company secretariat function. In the past this has often been primarily geared to providing reactive – and sometimes overly deferential – support. Looking ahead, the focus will need to be more on developing and agreeing with the non-executive directors a forward-looking work plan to support more searching boardroom debate.

9.59 This may well require an elevation of the role of the company secretary. For this reason the board as a whole must feel confident that any individual charged with these responsibilities has the stature to interact effectively and pro-actively with the non-executive director group. It is correspondingly important that whoever takes this role should be accountable to the chairman and the board and, as stated in the Combined Code (A.5.3), that both the appointment and removal of the company secretary should be a matter for the board as a whole.

9.60 In friendly societies where the same individual holds the positions of secretary and chief executive, the two roles should, ideally, be separated to remove any conflict of interest. Otherwise, the job of supporting the non-executive directors should be delegated to an individual who should report directly to the chairman in this capacity.

¹⁵ See 'Information and the company secretary' in chapter 11 of http://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf.

¹⁶ The ICSA best practice guidance on the duties of a company secretary includes at number 14 "Non-Executive Directors: Acting as a channel of communication and information for non-executive directors." See http://www.icsa.org.uk/pdfs/guidance/duties_co_sec_b_p_g.pdf

9.61 Key support roles would include:

- Identifying emerging governance (rather than simply compliance) issues on which non-executives need more extensive briefing;
- Structuring and co-ordinating analytic input from within the company, including briefings for non-executives by key managers, to respond to governance related requests by the non-executive directors;
- Facilitating communications between non-executives and the chairman and between non-executive directors;
- Administrative support to non-executives when they wish to seek independent advice;
- Conducting an annual analysis of the quality and timeliness of board papers.

9.62 The ICSA has kindly offered to draw up some additional guidance for Company Secretaries on offering support to non-executive directors. This guidance is aimed at life mutuals though it may be of more general relevance. It will be available on the ICSA website.¹⁷

Directors' remuneration

9.63 The most recent version of the Combined Code (July 2003) post-dates the introduction of the Directors' Remuneration Report Regulations 2002. The preamble to the 2003 Code states, therefore, that it no longer includes material in the previous Code on the disclosure of directors' remuneration. Although the Directors' Remuneration Report Regulations 2002 apply only to quoted companies, the Review recommends that all life mutuals should produce a remuneration report along the lines of that described in Schedule 7A of the regulations and conduct an advisory vote on the report at the AGM (as per S241A).

9.64 Those sections of Schedule 7A relating to share options will not be relevant to life mutuals (unless directors of mutuals are involved in ownership schemes involving subsidiaries). These are Section 3 subparagraph (2)(a)(i), all of Section 4 (relating to the Performance Graph), Sections 7, 8 and 9 (the treatment of Share Options in the information subject to audit) and Section 11 subparagraphs (2) and (3).

9.65 In addition, the data collected and published annually by the AMI and the AFS on adherence to key aspects of the Code, and the review of life mutuals' compliance with the Code to be conducted by the Treasury in early 2008, should cover both the directors' remuneration report and the holding of an advisory member vote.

¹⁷ See <http://www.icsa.org.uk/news/guidance.php>

Recommendation 13

All life mutuals should produce a remuneration report along the lines of that described in Schedule 7A of the Directors' Remuneration Report Regulations 2002 and conduct an advisory vote on the report at the AGM (as per S241A).

In addition, the data collected and published annually by the AMI and the AFS and the review of life mutuals' compliance with the Code to be conducted by the Treasury early in 2008 should both cover the directors' remuneration report and the holding of an advisory member vote.

9.66 A related issue is the design of performance related remuneration. Long-term incentive schemes should use performance criteria that properly reflect the best interests of members. Members of mutual life firms, as policyholders as well as providers of risk capital to the firm, will have different interests from shareholders in equivalent proprietary companies. The strategies that mutual life firms pursue and the performance criteria that will be used in long-term incentive schemes may both reflect this difference.

9.67 As discussed in Chapter 8, there is the difficulty of defining clearly what success means in a mutual. Shareholder value, which can guide a proprietary firm, is a concept for which it is hard to establish an equivalent in a mutual. Taking on new business, for example, has constantly to be reviewed in a life mutual in the light of the interests of existing members. At the same time, mutual members may not be wholly focused on individual financial returns and may also value other aspects of the firm, such as branch networks or matters relating to the broad interests of an affinity group.

9.68 Unsurprisingly, responses to the Review's consultation and the discussions with non-executives described in Chapter 8 suggest that there were some divergence views as to how best to measure the performance of the firm, both as it relates to the directors' objectives, and in terms of what issues non-executives should be seeking to monitor. The Review, therefore, commissioned some research work from Cazalet Consulting to look at this area. This was based on a series of confidential interviews with life executives in mutuals and proprietary firms. The following section is a digest by the Review of points to come out of this work. It is hoped that this will help to stimulate debate within the life mutual sector around corporate purpose and performance measurement.

Performance measurement

9.69 Non-executive directors of a life mutual face the need to keep under review a broad range of strategic issues and performance measures. In common with the boards of proprietary companies, they need to assess how successfully the business is progressing in terms of new business volume growth, product mix and contribution, market share, service standards and product performance measured as value ultimately delivered to policyholders. This has to be accompanied by a focus on efficiency in regard to policyholder charges as well as relative investment returns by asset class. Aggregate performance measures, such as embedded value or appraisal value (the former widely used by listed life company groups and by other listed groups, such as banks that have life company subsidiaries) can also provide a summary measure of performance for non-executives to monitor. Each of these measures takes into account, to a different extent, the value of future cash flows from new business – an important metric, given the long-term nature of many life policy contracts. From a board monitoring perspective, however, the problem is that such measures can be volatile

from year-to-year since they are highly sensitive to the underlying assumptions. Correspondingly, their real value to non-executives lies in understanding the factors driving any changes in these underlying assumptions.

9.70 In addition to these performance measures, however, non-executive directors of life mutuals must pay particular attention to financial management and the security of policyholders' interests. This encompasses not only the new book of business but also the in-force book. While the core performance metrics here are in essence the same as for proprietary companies, the main difference of course is that life mutuals have limited access to external capital. Correspondingly, from a corporate governance perspective, the stakes are higher: while it is possible for mutuals to raise money through the issue of subordinated debt, the amount that can be raised in an efficient way under current regulations is limited (and particularly hard to tap in the case of smaller life companies). Because limited external capital is available, whether to support growth or for balance sheet repair, non-executives of life mutuals have a particular duty to ensure that they understand the implications of the financial strategy that executive management is pursuing.

9.71 As a consequence, it is important that non-executive directors of a life mutual possess a good understanding of the financial strength of the enterprise, as set out in the newly refined range of realistic solvency measures, and through valuation and financial condition reports together with the organisation's financial policy objectives defined in the PPFM that is now required. What these and related measures should collectively provide is not just a set of stand-alone performance ratios but information and, above all, interpretation that will enable the diligent non-executive director to have much greater insight on the internal financial dynamics of the enterprise and an appreciation of how sensitive the financial position is to changes in underlying assumptions. This should in turn inform the periodic board review of how far the chosen financial strategy is meeting the best interests of mutual members.

10.1 The last chapter explored what measures might be taken to improve the internal governance processes within life mutuals, concentrating in particular on board effectiveness. In this chapter, the report returns to some of the wider issues around how the board itself is held to account, and how the specific issues highlighted in Chapter 5 concerning the role of members and other market monitors might best be addressed.

10.2 The first part of the chapter looks in more depth at possible ways of enhancing external market scrutiny of life mutuals. It then turns to the question of what actions firms might take to facilitate and encourage engagement by their members.

EXTERNAL SCRUTINY

10.3 As noted in Chapter 5, one of the most striking differences in accountability terms between a life mutual and a listed company is the differences in the amount of information life mutuals are required to make public.

10.4 The Review's consultation document asked the question:

"Listed companies are subject to the influence of 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?"

10.5 Respondents to this question were divided in their opinion with a narrow majority (56 per cent) suggesting that there were ways in which external market disciplines could be improved. Of these respondents the majority suggested that improved information should be made available to the market place. A few respondents took the view that the Review should seek to 'even-up' mutual market information to proprietary company standards by applying Listing Rules and Companies Act requirements for larger life mutuals. As one respondent said:

"Mutual organisations should improve the quantity and quality of information they provide to the public and to their policyholders."

10.6 As noted in Chapter 5, the Review does not share the assessment made by a minority of respondents that there is no scope for market disciplines to be improved. Dialogue with market monitors such as IFAs and rating agencies has confirmed this assessment. A consistent message from these monitors is that information on life mutuals is less easily found than it is on their proprietary counterparts. That this should be the case is not surprising. Life mutuals are subject to fewer formal information disclosure requirements than listed companies. As noted in Chapter 4 research commissioned by the Review suggests that some choose to publish information voluntarily, but many do not.

10.7 The Review's assessment is that there are a number of specific areas where publication by mutuals of the same information as listed companies could prove of value to all monitors, including members. Specifically the Review recommends that in future all large life companies should publish information on:

- Performance and strategy, in the form of an OFR. The OFR is currently voluntary for all firms but regulations making it a mandatory part of the annual reports and accounts for UK quoted companies are due to come into force for financial years on or after 1 April 2005. The OFR as described in the draft Regulations is designed to provide a balanced and comprehensive analysis of the business. It covers the company's objectives, strategies and key drivers of the business, focusing on more qualitative and forward-looking information than has traditionally been included in annual reports. The OFR is aimed primarily at shareholders (as opposed to other users of company accounts) and as a narrative statement is designed to be accessible to small investors. It is intended that the OFR be published with the annual report, but where shareholders have agreed to receive summary financial statements, there will be no requirement for the full OFR to be sent and shareholders will be notified of the availability of the OFR on the company website. The management of a life mutual is ultimately accountable to a dispersed membership that is at least as numerous as the shareholder base of a major quoted company. For this reason, as well as the importance of forward-looking, strategic information for members of a life mutual, the Review believes that the largest life mutuals, namely those that have more than £500 million of long-term insurance assets, should produce an OFR.

Recommendation 14

Large life mutuals should produce an OFR in the same way as quoted companies will shortly be required to.

- Directors remuneration. As recommended in Chapter 9, like the directors of a listed company, life mutuals' directors should prepare a remuneration report setting out the company's policy on directors' remuneration, including a breakdown of remuneration by director (including details of equity based incentives and pension benefits). Members should have an advisory vote on the approval of this report.

10.8 On current evidence, the Review's assessment is that it would not be proportionate to legislate to require firms to publish this information. This judgement rests to a large degree on the apparent willingness by the industry to itself take the necessary action to deliver better practice in this respect. To that end we expect the AMI and the AFS to monitor and publish information on the progress made by their memberships. Given the importance of better disclosure, the Review also recommends that the Government keeps the situation under close review with a view to deciding in 2008 whether more prescriptive action is warranted.

10.9 The Review’s assessment is also that there are general issues surrounding the information that is available to consumers on life firms’ performance. Specifically, current and prospective customers do not currently have easy access to comprehensive or reliable information on the performance of life funds – be they mutual or proprietary. Some information is made public, but inclusion of firms in ‘best buy’ tables is often voluntary on their part. That comprehensive information of this type is made generally available is a fundamental pre-requisite to a properly functioning competitive product market as well as to better member monitoring of life mutuals.

10.10 The Review therefore welcomes steps taken by the FSA in recent years to bring greater transparency to the life sector. In addition to measures already taken such as the introduction of realistic accounting and the publication of PPFMs, proposals (in the FSA’s CP202¹) to require firms to make available information on life policy payouts on surrender and maturity are particularly welcome. The Review urges the FSA to continue to build on this, and consider in particular what further information might be developed to give the members of life mutuals an impartial and informed perspective on policy performance and the sustainability of that performance.

BEST PRACTICE ON INVOLVING MEMBERS

Why members should be involved

10.11 In the light of the analysis in Chapter 5, the Review considers it important that members should be involved in the corporate governance of life mutuals. Their monitoring role is particularly important. Members are uniquely placed to represent an ‘ownership’ interest in the firm and are the closest analogues to shareholder interest in a proprietary company (though they differ in many respects as explored in Chapter 5). Other monitors exist, notably the FSA, IFAs, commentators and rating agencies, but their interests are different and ultimately cannot substitute completely for the direct interest of members, derived from their contractual relationship with the firm and associated membership rights. A number of life mutuals share this perspective. As two of the larger life mutuals commented:

“Essentially policyholders who are members should participate in the management of a mutual in the same way – and to the same extent – in which shareholders participate in the management of a proprietary company.”

“Royal Liver does not have shareholders but it is considered that we have a very active ‘ownership group’ in the form of the Delegation. We would contend that the Delegation is at least, and arguably more, in touch with the business affairs of the Society as are the shareholders of a proprietary company, and have the same collective powers as do shareholders.”

10.12 The Review has heard the argument that the directors of mutuals perform something akin to a trustee role, and that the mutual form is designed to avoid the need for members’ ongoing scrutiny. It is worth noting, however, that traditionally the Articles of mutual life offices have presumed a certain amount of engagement by members, which is why they typically confer on members certain rights to propose and vote on the appointment of directors, permit them to requisition business at general meetings and to requisition extraordinary general meetings. It can be argued, for this reason, that member engagement is an important element of the mutual model.

¹ “Insurance regulatory reporting: changes to the publicly available annual return from insurers”, September 2003.

10.13 Another potential reason for members to be involved is because of the nature of life products, which are often long-term, costly to exit, and opaque. Because of these features, it is desirable for the customer to have an on-going, high trust relationship with the provider. It is arguable that in that context governance is much more central to the life product transaction than it is where the buyer can easily exit from the relationship and buy a similar product elsewhere. This may serve to explain why many life offices have evolved as mutuals. It also suggests there is a stronger case for mutual life offices to pay attention to their member relations than in other mutuals, where exit is more easily achieved.

10.14 Directors have a duty to promote the success of their firm for the benefit of its members (be they shareholders or mutual members). To serve members' best interests the board must know what those interests are. The purpose of the firm will be set out in its Articles. But the fine judgements that a life mutual must take on its risk profile, its choice of strategic direction and so on must necessarily involve a certain amount of interpretation and presumption about the interests of members. For these judgements to be properly informed, they should be taken in the context of an ongoing dialogue between members and the board.

10.15 Finally, firms should consider involving members because active participation by members can bring business benefits. An active membership may add value through fostering loyalty or enabling the firm to know its customers better, and better position itself to understand and meet their needs. We are not aware of any firm evidence to support this in the life sector, but a number of building societies have cited this as a motivating factor behind their efforts to engage their members:

*"Building societies recognise that mutuality means more than just their structure, but informs the relationship they have with their members. Participation and engagement is key to connecting with those members and the evidence from the sector shows that members are keen to reciprocate this contact."*²

Consultation responses

10.16 The Review's consultation document sought views on member relations and on the idea that guidance might be provided on best practice voting arrangements, provision of information to members, and issues that should be put to a vote by members. All those that responded on this point were supportive of the Review's suggestion.

10.17 The consultation also asked for practical suggestions on how the Review might foster a better dialogue between life mutuals and their members. The vast majority of respondents to this question suggested that member panels were a good method of promoting member voice. Some respondents also suggested that non-executive directors should have a greater role in representing member interests and engaging more effectively with members.

² 'The Building Society Sector Experience of listening to members: September 2004', Building Societies Association

10.18 Evidence collected by the Review shows that while some mutual life offices have in place good arrangements for involving their members, others do not. In particular, in some cases, a firm's Articles may present fairly substantial practical barriers to all its members exercising their right to vote. As set out in Chapter 4, research commissioned by the Review suggests that about half of the life mutuals surveyed do not permit postal voting.³ A quarter do not allow proxy voting. A number of firms do not send a notice of their AGM to members, but instead rely on press advertisement.

Members' perspective

10.19 To gain a better appreciation of members' views on the nature of their role in firms' corporate governance and how they would like to see it evolve, the Review commissioned an external research company to conduct a piece of qualitative research into members attitudes. The research report is available on the Review's website.⁴ The findings of the research, which involved in-depth interviews with about 100 members of a diverse set of life mutuals, have informed the Review's recommendations.

10.20 The main findings of the research are:

- That mutuality has meaning for most members, defined principally by the absence of shareholders;
- Members have a very positive attitude to mutuality, and expect to benefit financially from taking out a policy with a mutual;
- Most (75 per cent) recognise that they are members of mutuals and consistently refer to themselves as such rather than as policyholders or customers;
- Most members, especially members of affinity-based mutuals, prefer to be relatively inactive and uninvolved in the firm, and act accordingly;
- A significant minority of 33 per cent prefer to be very or fairly active and involved, and behave accordingly. These individuals also favour more information disclosure;
- Most (75 per cent) are satisfied with the amount, quality and timeliness of information they receive;
- The majority feel their firms are accountable to them as members. This is demonstrated by the provision of information and being responsive to members.

10.21 The Review takes a number of key messages from this research:

- Members place a high value on their membership and have a very positive view of mutuality. This appears to be largely based on high levels of trust and a belief that mutuals can deliver superior financial performance;
- Consistent with the anecdotal information the Review has received, it confirms that the majority of members are not interested in becoming more involved in corporate governance. Neither do they wish to receive a greater quantity of information. Yet the provision of information is seen as one of

³ Since these figures were compiled one life mutual, Royal London, has gained its members' consent to the introduction of postal voting.

⁴ 'Attitudes of members of mutual life offices', RS Consulting, December 2004, www.hm-treasury.gov.uk/myners

the main ways in which firms demonstrate their accountability to members. In the light of this, it is important that the quality of information provided to members is adequate for their needs and properly reflects their interests;

- There exists a substantial cohort of mutual members with an interest in becoming engaged in the corporate governance of their mutual. This suggests that while engaging members may be difficult, it is certainly not impossible. In devising strategies for involving members, it will be important to distinguish between those who do not wish to be engaged and those who do. Many of these more activist members would like more information. This needs to be balanced against the disinterest of the majority and the cost of distributing information to all members. Firms should consider ways of making available additional information to those who want it, without sending it to all members.

Best practice guidance

10.22 To ensure that all members of mutual life offices have a reasonable opportunity to exercise their voice, the Review recommends that the AMI and the AFS work to devise guidance that promotes best practice. This should include:

3. Fair and accessible voting arrangements. While all life mutuals confer on members the right to vote, some have practices that restrict the ability of members to exercise that right. Processes should be fair, allowing members a genuine and informed opportunity to express their views. Some guiding principles are set out in Box 12;
4. Establishment of a member relations function, responsible for a member relations strategy, including:
 - Promoting dialogue with members;
 - Provision of information to members;
 - Facilitating discussion among members.

Recommendation 15

The AMI and the AFS should devise guidance that promotes best practice member relations. This should include guidance on fair and accessible voting arrangements as well as advocating the establishment of a member relations function, responsible for a member relations strategy. The guidance should cover promoting dialogue with members, provision of information to members and facilitating discussion among members.

10.23 This guidance is supported by an annotation in section D1 of the life mutuals Code (at Annex D), which emphasises the responsibility of boards to consider how dialogue with members can best be facilitated. Firms' policy for doing this should be clearly articulated to members. Where life mutuals have in place member panels or other member fora they would be regarded as performing the same role as institutional or major shareholders.

Box 12 Principles for fair and accessible voting procedures for members

The board should use the AGM to communicate with investors and to encourage their participation.

1. All members should have the opportunity to participate and vote in annual general meetings.
 - Prohibiting proxy voting and requiring personal attendance are barriers to members participating in AGMs. Firms are encouraged to remove these barriers and find ways to enable member participation.
 - Firms should consider using postal voting and/or secure electronic voting to enable member participation.
 - Where members' votes are delegated to elected representatives, firms should ensure that all members have the opportunity to nominate candidates and vote in the delegate selection process. Firms should ensure, to the extent that is possible, the active engagement of members in the electoral process.
 - A vote should be held even if the election is uncontested.
2. Members should be informed of the rules, including voting procedures, that govern annual general meetings.
 - Where proxy voting is permitted, proxy forms should be sent to members with the notice of the meeting. The form should explain that members are entitled to appoint a proxy and provide a space for members to write the name of the proxy.
 - Firms should disclose to members how any undirected proxies would be voted.
3. Members should have sufficient and timely information concerning the date, location and agenda of annual general meetings.
 - The Notice of the AGM and related papers should be sent to members at least 20 working days before the meeting.
4. Members should have full and timely information regarding the issues to be decided at the AGM.
 - The notification of the AGM should include all information necessary for members to make a properly informed decision on all matters relating to voting.
 - The papers should give equal regard to the directors' recommendations and any opposing recommendations.
 - Any recommendation from the directors should indicate why it is their assessment that the proposal is in the best interests of the members as a whole.
5. The results of the AGM should be made available, in a timely manner, to members.
 - Firms should make the results available on request and place the results on the company website.
 - If decisions taken at the AGM concern fundamental changes, such as amendments to the statutes, or articles of incorporation or similar governing documents of the firm, firms should consider sending this information directly to members.

Promoting good member relations

10.24 Measures designed to facilitate voting by individual members are unlikely, on their own, to achieve substantially improved member participation because, as noted above, the incentives on individuals are weak, and the costs relatively high.

10.25 Political scientists talk of the ‘collective action’ costs that deter people from getting together in a group of members. It is only when the costs of not acting are perceived to be high, as for the member groups that emerged from Equitable Life’s membership, or in the case of de-mutualisations, that participation can be expected. As one society observed:

“We have experimented with a variety of ways of, for example, notifying our members of our AGM... it makes little difference to the number of AGM attendees...it is possible that our low premium business means that our members are less interested or inclined to engage with the Society.”

10.26 Many life mutuals have nonetheless been very successful in conducting a dialogue with their members and encouraging them to engage, as have some building societies. Others have enjoyed less success. This suggests the need for more pro-active action by some life mutual boards to enter into a dialogue with their members. Those that are already active in this field might consider how their strategies can be further improved. Just as many proprietary companies now have an investor relations function, the Review sees considerable value in life mutuals establishing an explicit member relations function to develop and take forward a member relations strategy.

10.27 As noted in paragraph 10.22 above, a member relations strategy should comprise three main elements. Each is discussed in turn in the following paragraphs.

Dialogue with members

10.28 For many organisations, particularly larger firms, the majority of members will have little interest in engaging in dialogue with the firm and will see no benefit in doing so. In such circumstances there is considerable merit in creating a ‘funnel’ for member views. This involves tapping in to and making full use of the minority of members who do have an active interest in participation. Members can be involved in a number of different ways, for example:

- Some mutuals use member councils or panels to gather opinions and shape decisions. An example of this is to be found at the Britannia Building Society, which has a Member Council of 24 that meets eight times a year to discuss group policy with directors and senior managers. Members are selected randomly from among the society’s membership. It has no formal decision making role, but acts in an advisory capacity. The key challenge with this type of arrangement is in finding members who are willing to participate. Care also needs to be taken to ensure that the panel is broadly representative of the full range of member interests;
- Others have member parliaments or delegate systems. Members of these groups tend to be elected by the membership and in some cases exercise members’ voting rights on their behalf. They are mostly associated with mutuals that are affinity based. For example, Royal Liver has a delegate system, which involves members voting for a total of 220 delegates, who then attend a four-day AGM. Delegates elect from among themselves a chair of the AGM and have the right to place items on the agenda. This system is likely to be more costly than a member panel (because of the costs of arranging elections). If insufficient members are motivated to stand for

election or even vote, it also runs the risk of creating a powerful group of delegates who have little democratic legitimacy and who may exclude the views of the majority;

- Some mutuals have a member representative or representatives on their board. They may be directly elected by all members or elected by delegates. This type of arrangement has some attractions in that it provides a direct say to members at the decision-taking level. But this approach can potentially have serious adverse consequences in the life sector, where placing responsibility for the broad (and often conflicting) interests of a large and diverse population of members on the shoulders of one or two people could lead to narrow interests prevailing to the detriment of wider member interests. As discussed in Chapters 8 and 9 all non-executives should display the necessary skills and personal qualities to be effective board members. Member representatives should not be an exception in this regard.

10.29 The Review recommends that all life mutuals should endeavour to put in place adequate arrangements for taking into account members' views. We invite the AMI and the AFS to consider how best to promulgate information sharing on best practice among life mutuals. The Review does not consider there is a single model that all firms should follow. To be effective, member involvement must take into account the traditions and specific characteristics of individual firms. However, all firms should review their current arrangements (where these exist) and evaluate them in the light of the principles in Box 13. The Review also recommends that the AMI and the AFS develop these principles as part of the general guidance in recommendation 15.

Recommendation 16

All life mutuals should endeavour to put in place adequate arrangements for taking into account members' views. The AMI and the AFS should consider how best to promulgate information sharing on best practice among life mutuals. All firms should review their current arrangements (where these exist) and evaluate them in the light of the principles in Box 13. The AMI and the AFS should develop these principles as part of the general guidance on member relations.

Box 13 Principles for evaluating arrangements for taking into account members' views

1. Selection arrangements should allow all types and generations of member to be represented. Member representatives (be they delegates, panel members or board members) should be frequently refreshed (at least every six years) to ensure this is the case;
2. Selection arrangements should generate member representatives who are motivated and competent;
3. Any appointment to the firm's main board should seek to comply with the relevant Combined Code provisions (notably A3, and A4);
4. Member forums should be conducive to discussion of membership as well as customer issues;
5. Adequate information should be provided to member representatives to allow them to take a considered view on the issues before them.

Information to members **10.30** As noted earlier in this chapter, life mutuals are subject to fewer formal information disclosure requirements than comparable proprietary companies. These rules govern both the nature and the timing of financial and other information that is made available to key monitors. The effectiveness of monitoring by life mutual members and others could be enhanced through making available more comprehensive information of this kind.

10.31 The Review appreciates that mailing large amounts information to members may not meet their needs or indeed be a cost-effective means of communication. What is important is the quality and the pertinence of the information, not the quantity. It may be sufficient to provide summary information (for example of the kind provided by building societies to their members or perhaps in the form of a short newsletter devoted to membership issues), together with guidance on how to access more detailed information on request or on the firm's website. The Review invites the AMI and the AFS to offer guidance on best practice in this respect, as part of the guidance in recommendation 15.

10.32 One life mutual has expressed concern to the Review that life mutuals constituted under the Companies Act or under Private Acts would be obliged by law to send their full report and accounts to all members entitled to receive notice of general meetings. The Review is glad to note that the Department of Trade and Industry is already planning to amend the Companies Act to enable more companies to issue Summary Financial Statements.

10.33 The Review considers it particularly important that communications should include:

- Information on the firm's performance. Building societies provide to their members a short form of their accounts. The Review recommends that similar practice is adopted by life mutuals;
- Information on directors' remuneration (see recommendation 15);
- Forward looking strategic information of the kind provided in the OFR (see recommendation 15);
- Where appropriate, notification of large transactions. It is a recognised principle among listed companies, building societies and co-operatives that shareholders or members should be notified and have a say in major transactions. As noted in paragraph 5.21 listed companies are subject to a threshold of 5 per cent (measured by assets, profits, turnover, consideration and gross capital) for notifying shareholders of major transactions, and must put the matter to a vote at AGM if it exceeds a 25 per cent threshold. Building societies must similarly seek members' consent to large transactions to acquire or establish a new business. A threshold of 15 per cent of the value of the society's funds applies. For the reasons set out in Chapter 6, the Review recommends that life mutuals adopt similar practices. The Review looks to the AMI and the AFS to devise best practice guidance on appropriate thresholds.

Recommendation 17

Life mutuals should adopt the practice of notifying members of major transactions. Members' consent should be sought in the case of very large transactions. The AMI and the AFS should devise best practice guidance on appropriate thresholds.

10.34 Many companies have investor relations pages on their websites. In a similar vein, some mutuals have member areas or pages on their websites. These typically provide easy access to information published by the firm (such as annual reports), updates on recent initiatives, reports of AGMs, and presentations on issues of potential interest to investors. Life mutuals might look at ways of ensuring that their websites follow best practice in this respect, learning from others, and where necessary establishing their own member relations pages.

10.35 New technology offers a number of interesting opportunities not only to reach more members but also to do so cost-effectively. For example, Nationwide Building Society has webcast its AGM as well as hosting an on-line members forum, with the Chief Executive answering email questions in real time. Some societies are looking at the introduction of electronic voting for their AGMs. This suggests there is ample scope for innovation.

Discussion among members **10.36** As noted above, members of some life mutuals can experience difficulties in contacting their fellow members, because their firms do not hold sufficiently good quality information to enable contact to be made or do not give members easy access to it. This can have the effect of limiting the ability of members to group together to requisition business. Wherever possible firms should make this information available to members. If it is not possible, due to data protection issues, firms should either contact members on behalf of other members, or if that would be disproportionately costly, firms should make available specific fora in which members can meet each other, for example, in the members' area on their websites. The existence of this possibility should be publicised.



CONCLUDING REMARKS

Taking forward the Review's recommendations

11.1 Good governance is essential to all forms of undertaking. It provides the checks and balances that ensure that firms are run efficiently and meet the objectives of their owners, be they shareholders in a proprietary firm or members of a mutual. The starting point for this Review was to consider the governance framework for mutual life offices and to compare and contrast it with the framework in place for comparable proprietary companies. It is apparent that life mutuals face a number of specific corporate governance issues as a result of their particular form of ownership and the nature of the business they conduct. These are both intrinsic to the mutual form – such as the absence of concentrated ownership – and practical – for example the differences rooted in the legislation governing mutuals and in the exit terms of contracts. This report aims to address these issues and contains a range of recommendations that aim to provide the basis for life mutuals to ensure that their governance will compare very favourably to best practice in proprietary firms. But the success of any Review of this type should be judged not from its recommendations but from the extent to which it promotes enduring change.

11.2 It was clear at the beginning of the Review that the sector had done much and was doing much to address the issues raised by Lord Penrose in his Report on Equitable Life. A number of boards have, for example, taken steps over the last few years to adjust their composition and appoint an increasing number of talented and experienced individuals both from within the life insurance industry and outside. What this showed the Review was that the boards and management of individual firms saw the benefits to themselves and their members of good governance. The survey work showed that governance is already good in a number of life mutuals – but clearly also less good in others. This indicated that a high standard of governance is not beyond the means of any firm in the sector.

11.3 What has also become apparent is the strong group identity of the life mutual sector – the realisation that just as problems for any one firm could tarnish the whole group, the collective interest lies in protecting and improving the mutual brand. And good governance should be part and parcel of mutuals playing to their strengths; accountability and transparency are very much in the spirit of the mutual form – but in mutuals, as elsewhere, they require effort and vigilance if they are to be sustained.

11.4 It is, therefore, to the sector itself that falls a large part of the task of ensuring that there is enduring change in the governance of mutual life offices. The heterogeneity of corporate form in life mutuals has undoubtedly inhibited collective action in the past so the formation of the AMI is a very welcome development. The Review looks to the AMI, working with the AFS, to consult with their members on the draft annotated Combined Code for life mutuals with a view to agreeing a final version for adoption by the beginning of financial year 2005-06. To them also falls the task of updating the annotated Code in the future, in step with reviews of the main Code, and the publication of annual statistics on the adoption of key elements of best practice, both Combined Code and other issues, including information disclosures such as the OFR and directors' remuneration report. To make this work, each and every firm will have to decide what steps it needs to take. The Review calls on the chairman of each mutual life office to set matters in motion in his or her own firm.

11.5 The Review also calls on the AMI and the AFS to develop the principles outlined in Chapter 10 into detailed best-practice guidance for fair and accessible voting procedures for members and on good member relations.

11.6 The Review is confident that the sector can deliver but warns against complacency. To assist chairmen and trade bodies in ensuring these issues continue to receive the attention they deserve, the Review would like the Treasury to review progress with respect to the Review's recommendations in early 2008. This is a reasonable timeframe over which to judge firms' commitment to change and to see real progress. If this commitment is not forthcoming and progress not seen, the Review urges the Treasury then to consider regulation for life mutuals in areas where equivalent regulations or other binding rules exist for equivalent proprietary firms as well as measures specifically designed to take into account the governance features of mutuals.

11.7 The Review also welcomes the continuing changes that the FSA is making to the regulatory environment for mutual life offices. The regulator's focus on making directors' accountable for the firm's operations and its continuing appreciation of good corporate governance as a complement to its regulatory objectives can only help to ensure that the Review's recommendations are implemented by firms and that lasting change is achieved. Good governance is about making sure firms are run well. This can but help the FSA. The Review urges the FSA to build on current efforts to secure good governance as an essential step towards promoting its regulatory objectives. It is particularly important, therefore, that the regulator should monitor the overall effectiveness of boards rather than just the suitability of individual directors. In addition, the FSA should be seeking contact with non-executive directors as a regular part of their interaction with supervised firms.

11.8 The Review is pleased that the FSA shares the objective that, by following such guidance in the annotations, firms should be able to demonstrate that they have had regard to FSA's own high-level guidance relating to corporate governance. This is important for ensuring that the annotated Code is adopted throughout the sector, a fact that needs to be borne in mind during the consultation on the draft annotated Code mentioned in paragraph 11.4.

11.9 To the FSA also falls the specific task, in 2008, of carrying out work to look in the round at the extent to which the Code is adopted across the sector. In particular, it would be important for the FSA to understand firms' reasons for not adopting the annotated Code as a model for governance, or for choosing to explain rather than comply with a particular provision of the Code, in order to understand whether there are any generic regulatory issues that may need to be addressed.

Lessons for other mutuals

11.10 As the opening paragraph of this statement indicates, a recurring theme throughout the Review has been the universal importance of good governance. It matters not only to life mutuals and proprietary firms, but also other financial mutuals, other forms of mutual and indeed to charities, the public sector, and trust such as pension funds and unit trusts. Wherever there is separation of ownership and control, some form of corporate governance is required. Good governance is essential to the effective and equitable operation of any complex enterprise.

11.11 The terms of reference of the Review directed the Review to consider, where appropriate, general principles for other types of mutual. Throughout the Review has compared and contrasted the situation in the mutual life sector – the theoretical governance issues, the legislation and the current best practice – with that in other forms of mutual, particularly financial mutuals, and most obviously building societies.

11.12 The building society sector has at times faced criticism on governance but has developed a good record on working together to raise the bar of best practice in governance and other areas, for which the Building Societies Association can take considerable credit. The BSA published earlier this year its own annotated version of the Combined Code for its members and publishes statistics on a number of governance issues. The Review hopes and expects the good work to continue. The Review also applauds the efforts by Co-Operatives^{UK} to update its own governance code and to drive the adoption of best practice in that sector.

11.13 While the principles of good governance that we have sought to apply during the Review remain universal, the recommendations relate specifically to life mutuals. This is largely a reflection of the progress already made in other sectors and discussed above. But the Review's close focus on life mutuals relates also to the specific characteristics of life product that make good governance especially important. Governance may be relatively good and improving in these other types of firm, but even their most ardent supporters might hesitate to declare it perfect: the key difference with life insurance mutuals is that the products are particularly complex, of long duration and exit from them and thus from the firm is difficult or expensive. While a saver or borrower can have a very long relationship with a building society, the products are comparatively straightforward, performance is easy to evaluate, and exit tends to be simple. In the general insurance sector, where mutual firms are less common, products are relatively simple products and of a short term nature. The special attributes of financial mutuals mean they all have a great deal to offer in all these sectors but the fiduciary duty of the board – and the non-executive directors in particular – with respect to members, as well as the need for adequate information disclosure and mechanisms to ensure adequate member voice, are especially strong in life mutuals.

11.14 That said, the issues raised in this report and the recommendations of the Review will be of interest and direct relevance to other forms of mutual. The Review suggests that all such firms review their current governance arrangements in the light of the principles and practices discussed in this report.