

INDEPENDENT REVIEW OF THE CORPORATE GOVERNANCE OF MUTUAL LIFE OFFICES – CONSULTATIVE DOCUMENT

I am responding in a private capacity, but I was Chief Executive of Clerical Medical (1995-2001), responsible for leading its demutualisation and am now a non executive director of Nationwide. I was also the Halifax Executive responsible for the integration and management of Equitable when Halifax bought Equitable's operating assets in 2001.

Q1 I believe that the Combined Code does provide an appropriate framework for mutual life offices. In the case of Clerical Medical we had a non executive Chairman, a majority of independent non executive directors on the Board and complied with most of Higgs and Smith recommendations. Our biggest exception was that we did not insist on a non executive director leaving the Board after 6 years (justified in our view by the complexity of a life office). We always used specialist search consultants to recruit non executive directors and the Board always set out the specification of the required qualifications of the individual that it was seeking to recruit.

The key corporate governance issue for any company is the quality of directors and at the time of demutualisation Clerical Medical's Board included Charles Nunneley (Deputy Chairman, Flemings, later Chairman of Nationwide), John Hoskyns (Chairman of Burton), Murray Stuart (Chairman of Scottish Power), Michael Moore (Chairman of Tomkins), Malcolm Argent (Director of BT), and Ralph Quartano. They all (see Q5 and Q6) fully understood the key issues concerning the With-Profits Fund and bonus distribution and all made a major contribution when we demutualised. This was done early (1996) and from a position of strength, but the Board insisted on a structured process including a full auction from potential buyers.

Q2 I can see no reason why mutual life offices should be treated differently from listed companies. 'Comply or explain' is a good dictum; given the lack of institutional shareholders, FSA should satisfy itself of the exceptions to the Code. For the record, Nationwide responds to the Code exactly as if it were a PLC.

Q3(i) The roles of finance director and appointed actuary should be separated (we did so in 1995). The finance director is responsible for all commercial aspects (balance sheet, cost control, product profitability, etc) while the appointed actuary should be responsible for bonus declarations, PRE, premium rates, etc. The appointed actuary should not be a member of the Board and should submit to a full peer review of his/her work.

Q3(ii) There should always be a majority of non executive directors.

Q3(iii) I would not advocate a special Board Committee to deal with actuarial matters. A basic understanding of a mutual life office is possible for any intelligent non executive

(see Q4 below) and all major actuarial issues should be debated and agreed by the full Board.

Q4 Generally I believe that the information and advice available to non executives of mutual life offices is sufficient to enable them to exercise oversight. There may well be a case for a new non executive attending a session with a firm of actuarial consultants (Tillinghast, say) to ensure that he/she is receiving all necessary information (it is much more difficult for a non executive to detect serious omission of information than any other defect). It is then up to the non executive to insist that the information given is intelligible and sufficient for judgement to be exercised. Most actuarial papers should be as or more straightforward than those of a wholesale banking business.

I have in the last ten years been a member of Halifax's Asset Liability Committee and that of Nationwide. I was also a member of the Audit Committee set up to review Halifax's Treasury operation. I attended (at Halifax's expense) a two day seminar on Treasury provided by PWC, which was very useful. I found all three committees useful and worthwhile. Most papers presented were clear and could allow proper judgement to be made. In those cases where this was not the case, the committee insisted on a personal presentation by the author which allowed sufficient questioning so that a proper understanding of the issue emerged. Generally it was 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.

Q5 Non executives of any business should insist on receiving sufficient information so that

- (i) they understand the key financial drivers of the business
- (ii) they can be sure the stakeholders are being treated equitably
- (iii) they understand the key risks facing the business

They will always be reliant on the executives for the provision of management information and other key data, including valuations. In this context it is the responsibility of management to provide all such data and for its accuracy.

Q6 [Confidential remark deleted]

Q7 I cannot see how policyholders can play a more active role. Governance of the vast majority of PLCs rests with a small number of powerful institutions that are beginning reluctantly to use their voting power. Small shareholders are totally ignored (unless there is a hostile bid for the company, when they suddenly become quite important!). Policyholders will act in their own interests and not necessarily in the interest of the company as a whole. A major purpose of the Board (see Q5 above) is to ensure equity of treatment between different types of stakeholders. In my view this can best be done by a Board, the majority of whose members are independent non executives of good quality.

It is only the directors, who owe duties to the company, that can ensure the appropriate treatment and balancing of interests between the different stakeholders. This cannot be done by members in the mutual or shareholders in the proprietary company because they simply do not owe duties to the company as a whole - company law does not put such duties on members or shareholders.

Q8 Individuals' appetite for risk is subjective and variable (particularly when they have the benefit of hindsight). A Board should (through the Chairman's Statement) make clear its strategic direction, but I cannot see how it can take into account "policyholder's attitude to risk", since this is not measurable. A mutual will tend to have to follow a more conservative investment policy than a PLC and, in particular, may be forced to sell equities at a low point (and therefore the wrong point) in the cycle. A PLC has the option of getting further capital from the market, although the cost of that capital can be high.

Q9 I have recently become a director of Nationwide Life, a very straightforward life company with simple products and a good sales process; Nationwide Life is a wholly owned subsidiary of Nationwide and therefore a sort of mutual (certainly not a PLC). On the basis of my experience to date FSA's only involvement has been through Nationwide's 'Arrow' Report, which was very long on detail but short on substance.

Q10 Yes. I believe that FSA should meet all new non executives on appointment. The FSA should make clear the non executive's responsibilities and give a point of contact for future reference if the non executive develops any concerns.

Q11 A life office (mutual or PLC) needs to write significant new business if it is to be profitable. The ability to write new business will depend upon past performance, premium rates, projections and commission. Non executives and the FSA should make checks that all of these criteria are properly controlled and measured. A dash for short term growth (on the wrong terms) is as likely to occur for a mutual or a PLC (in the latter case, accompanied by a rise in the share price!). Both types of company will suffer and in the case of a mutual will lead to its demutualisation on poor terms and with a complete change of management. It is probably worthwhile to look at UK Provident's takeover by Friends' Provident (early 1980s?) in this context.

Q12 & 13 I have no doubt that efficient financial mutuals can offer customers better product terms than equivalent PLCs. In the case of Nationwide, we calculate (through an audited process) the benefit to our members and include the figure in our annual report and accounts. The benefit is currently of the order of £500 million per annum. I am confident that customers of an efficient mutual life office also benefited and for the same basic reason, that shareholders having made a one-off significant capital injection or payment to members then require a demanding return (one of the possible purchasers of Clerical Medical used a discount rate of 10% in the valuation of our business but would have demanded a return on capital of 17½%; this would not have been possible, but their management did not understand this).

A mutual Board should retain mutuality subject to these factors:

- (i) the mutual must be able to recruit and retain top quality management. (This is currently relevant in the life sector where in today's environment a medium sized mutual would struggle to do so.)
- (ii) The mutual must be efficiently run. The Board must satisfy itself that any lack of shareholder discipline (see Q11) does not permit inefficiency. Clear efficiency KPIs must be set and met.
- (iii) The mutual must not suffer from a lack of capital or access to capital. Scottish Equitable and Clerical Medical were the first two offices to demutualise from a position of reasonable financial strength. Both offices felt that their policyholders would suffer from a lack of investment freedom if they remained mutual and continued to grow. A major but reducing threat facing building societies is the short term attraction of a one-off payment against the long term advantage that a customer receives from a mutual. I do not think that regulators can or should interfere in this issue.

The consequences for members/customers on demutualisation are increased security, but at a cost of (often significantly) reduced returns. With-Profits customers should benefit in the longer term from increased investment freedom of their fund, but only if the demutualisation is properly structured with adequate member safeguards.

Q14 All financial mutuals should write to all their members on an annual basis giving a report on progress, key financial information, key performance indicators and directors' remuneration. Members should be encouraged to vote on all major issues including directors' remuneration. All financial mutuals should have to comply with Higgs/Smith or explain why they have not complied. This should not just be a question of good practice, but should be compulsory.

Q15 & 16 No response.

General

In my view your questions omit the key issue. A company's performance (mutual or PLC) will depend very heavily on the quality of its Board. If a company does not follow Higgs spirit in his recommendations, then it is unlikely to get a good quality Board. Higgs is therefore necessary but not sufficient. There also needs to be a source of good quality directors prepared to serve on a mutual Board. Remuneration is not relevant in this context, but four factors are working to deter good people from becoming non executives:

(i) Personal reputation. The life sector is so unpopular now (particularly with politicians and the media) that it must be very difficult to recruit new non executive directors of quality.

(ii) Financial risk. The existence of Equitable's law suit against its previous Board is of real concern. If this law suit is successful, then there will be no chance of getting good quality non executives. [Confidential remarks deleted.]

(iii) FSA. There is concern over FSA's enforcement powers and particularly the 'kangaroo court'. Whilst enforcement powers are clearly needed, there is a definite perception that the balance with FSA is guilty until proven innocent, rather than the historic English law position.

(iv) Red tape. The role of a good non executive should be balanced between encouragement of management and strategic development on the one hand and policeman on the other. Recent events including Equitable have shifted this balance. Any further shift towards the policeman type role will make the role of a non executive unrewarding.

There have been significant changes to corporate governance since Equitable's failure. I would hope that this review will take into account these changes and will not change the balance of a non executive's role any further (subject only to insisting that mutuals treat Higgs in the same way as PLCs).

Robert Walther