

REVIEW OF THE GOVERNANCE OF LIFE MUTUALS

It is with pleasure that I provide you with Royal Liver's observations on the Consultation Document into the Governance of Life Mutuals. This response is on the basis of the principles and practices of Corporate Governance undertaken within Royal Liver. It is not intended to reflect the views of any other Mutual Organisation.

BACKGROUND

Royal Liver is an Incorporated Friendly Society, registered under the Friendly Societies Act, 1992, established in 1850 operating throughout the United Kingdom and the Republic of Ireland. We currently administer approximately 5 million policies on behalf of approximately 1.5 million policyholders and our total net assets are approximately £3 billion.

The business of the Society is under the control and direction of the Committee of Management which is obliged to act with prudence and integrity, in the best interests of the Society's Members in accordance with best practice, with the Society's Memorandum and Rules and with all relevant legislation.

Under its current Rules, the Committee of Management consists of not more than 11 members. At the time of writing there are 9 members of the Committee of Management, 5 of whom are Executive Directors, the Chairman is Non-Executive, and was independent on appointment on 1st March, 2003 and there are 3 other Non-Executive Directors, including 1 who was elected from the body of the Delegation. All members of the Committee of Management are elected to office by the Society's Delegates at General Meetings and must submit themselves for re-election in accordance with the Society's Rules.

A Delegation System has been in existence since 1886, whereby the Members of Royal Liver elect fellow Members to act as the sole representative body for the Members and who are authorised to take decisions on behalf of the Membership at General Meetings of the Society. Delegates are elected to office for 6 years and are able to seek re-election provided that they are able to fulfil the eligibility criteria set out in the Society's Rules in both instances. It should be noted that they may be opposed for their seat by any other Member of the Society as long as they fulfil the same criteria.

Currently, there are approximately 220 Delegates representing the Members and they are split into 14 Electoral Areas within the UK and ROI in proportion to the numbers of policies in force in those particular Areas (by reference to post code groupings in the UK and County Boundaries in the ROI).

Royal Liver is regulated by the Financial Services Authority in the UK and the Irish Financial Services Regulatory Authority in ROI.

Although there is no current requirement for Friendly Societies to do so, Royal Liver complies voluntarily with the Combined Code of Corporate Governance adapting the principles and practices as appropriate to its status as a Mutual Incorporated Friendly Society.

GOVERNANCE FRAMEWORK

It is noted that the terms of reference of the Review are to consider the Governance Framework for Mutual Life Offices in comparison with that for comparable companies and, where relevant, for listed companies.

As stated above, Royal Liver's Committee of Management comprises 5 Executive Directors and 4 Non-Executive Directors, one of whom is a former Delegate of the Society. It is, perhaps, also worth repeating here that all of them are obliged, by the Society's Memorandum and Rules, to act in the best interests of the Society's members.

At the present time a review is being undertaken of the numbers and the balance of skills, competencies and knowledge on the Committee of Management and a report was presented to the Delegates at the AGM in May, 2004 which indicated that the Society is aiming to move towards having 11 members of the Committee of Management by recruiting an additional 2 Non-Executive Directors. The Delegation debated the report and were clearly in favour of the proposals made.

Royal Liver currently has 2 sub-committees of its Committee of Management - an Audit, Risk and With-Profits Committee and a Remuneration Committee. Both Committees comprise solely of the Non-Executive constituency, the former frequently invites the Chief Executive, the Corporate Services Director, the Head of Internal Audit, the With Profits Actuary and the Compliance Officer to be in attendance at its Meetings, and the latter invites the Chief Executive to discuss proposals to be made to Annual General Meetings in respect of the remuneration of the Executive constituency. It is also intended to establish a Nominations Committee to drive the process for the recruitment of additional Non-Executive Directors to the Committee of Management.

The Committee of Management regularly discuss Corporate Governance at its monthly Meetings and it is considered that we are able to demonstrate to the Regulators, and indeed our Members, that we are adhering to the principles and practices of the Combined Code of Corporate Governance. It is believed that the Committee of Management acts in largely the same way as the Board of a proprietary company in terms of its legal and regulatory responsibilities.

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 those shareholders.

O'Sullivan and Diacon (ref. S3.16 of the Consultation Document) contend that the absence of shareholders eliminates the ability to discipline ineffective management.

However, you may wish to note that Royal Liver's Committee of Management is elected by the Delegation and has its remuneration determined by that body.

It is, therefore, considered that the role of the Committee of Management at Royal Liver is largely similar to the Board of a proprietary company. Although we have a responsibility solely to our Members and the proprietary board solely to its shareholders, the roles and responsibilities in relation to governance and management are fundamentally the same.

PENROSE INQUIRY INTO EQUITABLE LIFE

There is much emphasis in the Review on the Penrose findings. Whilst clearly there are lessons to be learned from the events at Equitable Life, it is our view that the problems experienced did not relate directly to Equitable's Corporate structure but were specific to many factors relevant to Equitable and its management as well as the Regulatory and Governance framework in existence at that time.

There have been many significant improvements to the FSA's Regulatory framework in the intervening period. Examples include the Approved Persons regime, the governance of with-profits business, the development of the Principles and Practices of Financial Management, Realistic Solvency requirements, and Individual Capital Assessment. Indeed it is our view that had these been in place at the time, many of the issues identified by Penrose may have been avoided.

There are several specific observations included in the Consultation Document in relation to the Penrose Inquiry upon which Royal Liver feels it necessary to comment:

- *It is stated that there was ineffective scrutiny and challenge of the Executive in relation to valuing liabilities, assessing the liability implications of new products and identifying and monitoring risk.*

The Committee of Management of Royal Liver receives detailed Valuation Reports, new product launches require its approval and, the Audit, Risk and With-Profits Committee is in place to monitor risk.

- *It is stated that Equitable's Board had insufficient knowledge and skills to provide an effective challenge to the Executive in critical areas and so, the Board's dependence on Actuarial advice was total. None of the Non-Executive Directors had relevant life office experience or relevant qualifications and more specifically, none of them had relevant skills or experience of Actuarial principles or methodologies. It goes on to say that the Non-Executive Directors were so dependent on Actuarial input from the Executive, in particular from the Chief Executive/Actuary, that they were largely incapable of exercising any influence on the Actuarial Management of the Society.*

In practice, it is not possible for the Non-Executive constituency of a Board to cover each and every skill or discipline normally associated with the type of business activity undertaken by a Life Office. However, Royal Liver's Non-Executive Chairman is an Actuary with wide life industry experience, another of its Non-Executives is also an Actuary, another is widely experienced in the financial sector and the other is formerly a Delegate. As stated above, it is intended to supplement the numbers and skills of the Non-Executive constituency.

The Committee of Management also receives detailed Actuarial advice from its External Consultant Actuaries, and its in-house team on all actuarial matters.

- *It is stated that the Equitable Board was not subject to effective external scrutiny or discipline. It is asserted that shareholders, whose capital is at risk in the event of mis-management, will call the Board to account but in a Mutual, where policyholders are the source of risk capital, it is difficult for them to call the Board to account.*

Royal Liver would contend that it has a very effective arrangement for external scrutiny by virtue of the Delegation System and the format and style of our Annual General Meeting. This takes the form of a 4 day conference and is attended by our Delegates and it is common for 200 to be present for the duration of the Meeting. In addition to the normal Statutory items of business dealt with at the AGM of a proprietary company, and items proposed by the Committee of Management, Delegates can and do place items on the Agenda by giving 28 days written notice and those items are published in the Notice calling the Meeting and all items on the Agenda are decided by the votes of the necessary majority of Delegates voting at the AGM. It should be noted that the Delegation elects an individual from its own body to Chair the AGM. As mentioned earlier, it also elects the members of the Committee of Management and determines their remuneration following a recommendation being made by the Remuneration Committee.

Also, under the Society's Rules, a Consultative Committee of 12 Delegates meet with the Committee of Management on a quarterly basis to consider any issues referred to it by a Resolution of a General Meeting of the Society. This Committee acts as a very useful communication bridge between the Committee of Management and the Society's Members and Delegates throughout the course of the year.

As previously stated, the Society also has Policyholder representation on the Non-Executive constituency of the Committee of Management.

- *It is envisaged that there is some further scope for the FSA to consider how their powers may be exercised to address the problem of unbalanced or ineffective Boards.*

Royal Liver has a degree of confidence that the FSA would be content with our arrangements in this regard.

It is hoped that these comments demonstrate that the Committee of Management of Royal Liver is suitably accountable to its Members and that there is a healthy level of Member involvement in our governance arrangements.

REGULATION

I have already mentioned examples of the recent significant improvements to the FSA's regulatory framework within the comments made in relation to the Penrose Inquiry.

In addition, your Consultation Document acknowledges the imminent shift in responsibility from an Appointed Actuary to Boards for actuarial aspects of the business. You may wish to know that Royal Liver has already appointed a Valuation Actuary and a With-Profits Actuary into its in-house Actuarial Team.

It is, therefore, considered that the responsibilities of the Society's Committee of Management in relation to governance are adequately defined by the current FSA regime and are clearly understood by the members of the Committee of Management.

QUESTIONS

The Consultation Document sought responses to 16 questions and it is hoped that our comments which follow will be helpful to the Review.

QUESTION 1

To what extent does the current guidance on Corporate Governance, particularly the Combined Code, provide an appropriate framework for Mutual Life Offices? Would another approach be more effective?

It is considered that there are many similarities in respect of governance issues between a relatively large mutual like Royal Liver and a proprietary company. Although Royal Liver, as a Mutual Incorporated Friendly Society, is not obliged to comply with the Combined Code, we do comply on a voluntary basis, adapting the principles and practices as appropriate to our Corporate status.

I have already covered the election, roles and responsibilities, sub-committee structures, skills and experience of Royal Liver's Committee of Management elsewhere in this response.

The Committee of Management meets monthly to determine strategic direction and review operating, financial and risk performance. A comprehensive package of information in respect of each of the items of business on the Agenda is issued to the members of the Committee of Management in advance of the meeting. The Non-Executive Directors have the opportunity at the meetings to challenge any information provided and make further enquiries or seek more debate, as appropriate, on any particular issue.

The Society's Annual Report and Accounts are prepared in accordance with the Friendly Societies (Accounts and Related Provisions) Regulations 1994 and the ABI's Statement of Recommended Practice on Accounting for Insurance Business issued in 1998. An Independent Auditors Report to the Members is included which outlines the respective responsibilities of the Committee of Management and Auditors, the Basis of Audit opinion and the Auditors opinion.

It also makes the necessary disclosures in terms of the Committee of Management's emoluments and outlines the responsibilities of the Remuneration Committee to recommend to the AGM its proposals for a remuneration package for the Executive members of the Committee of Management.

It is believed that Royal Liver is able to demonstrate its compliance with one of the major recommendations of the Higgs Report that has been incorporated into the Combined Code in that it is felt that we have a Committee of Management of an appropriate size and are moving imminently towards a position whereby at least half of its members are independent Non-Executive Directors, whilst still retaining strong Executive representation.

Royal Liver already has in place an Audit, Risk and With-Profits Committee and a Remuneration Committee comprised solely of Non-Executive Directors and it is intended to establish a Nominations Committee. In addition, we have Non-Executive Director representation on a Subsidiary Board and this is likely to be extended to other Subsidiary Boards. There is also a Non-Executive attendance at the meetings of the Society's Investment Strategy Group.

It is difficult to argue against the "comply or explain" principle and it is clearly as relevant to mutual life offices as it is to proprietary companies. However, unless organisations like Royal Liver are obliged to comply with the Combined Code, the principle remains largely academic. If, however, the outcome of the Review is to establish a Code specifically tailored to suit the circumstances of Mutuals and, in particular, Incorporated Friendly Societies such as Royal Liver, it would seem appropriate to embrace the principle of "comply or explain". Clearly we would be interested in the detail of the Code that may be developed in this regard.

There are some aspects of the current Combined Code that are not relevant or inappropriate to Royal Liver and other mutuals, for example, the Section dealing with Dialogue with Institutional Shareholders. However, we believe that the communication channels that we have with our Delegates and the Consultative Committee together with the style and format of our Annual General Meeting are more than adequate in this regard. A further example is that share options schemes are obviously not part of Royal Liver's remuneration package for its Committee of Management.

QUESTION 2

What is the best way of securing Mutual Life Offices' compliance with Corporate Governance best practice?

In the same vein as our reply to Question 1, we would clearly need to see the detail of any new Code that may emerge before committing to mandatory compliance. In the meantime, of course, we will continue to comply with best practice on a voluntary basis. In addition, the FSA undertake Project Arrow visits in relation to Corporate Governance.

Royal Liver is a member of the Association of British Insurers (ABI) and the Association of Friendly Societies (AFS). Perhaps these trade bodies could be engaged in the development of any new Code and act in a 'supervisory-type' role such as they undertake for example to oversee compliance with the code for genetics.

QUESTION 3

In your opinion should the ownership structure or the nature of the business conducted by a Life Mutual affect the composition or structure of its Board? If so, how?

I have already covered matters relating to the balance between Executive and Non-Executive Directors in paragraphs 2, and 3 and the final paragraph of the section of this response headed "Governance Framework" as well as part of the answer to Question 1 on page 6.

It is clearly advantageous for Non-Executive Directors to have some specialist knowledge. I have outlined the professional skills, qualities and experience of Royal Liver's current Non-Executive Directors as part of the section of this response headed "Penrose Inquiry into Equitable Life". All of our Non-Executive Directors are Approved Persons. I have also confirmed that a review is being undertaken of the skills, competencies and knowledge on our Committee of Management and that we are looking to recruit an additional 2 Non-Executive Directors.

In addition to the skills currently in place, other types of knowledge and experience relevant to the conduct of life business in a mutual may include sales/marketing, legal/regulatory, retailing, institutional investment, information technology, strategy development, etc.

It is considered that Royal Liver's Committee structure - Audit, Risk and With-Profits, Remuneration (and the proposed establishment of a Nominations Committee) is adequate and effective.

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? In what ways might it be improved? If more information and advice is needed, what are the resource implications? Do similar issues arise for the Non-Executives of other complex businesses, such as wholesale banking or science based businesses?

The Committee of Management receives advice from the Appointed Actuary on appropriate issues in addition to information and recommendations from its in-house Actuarial Team. These include detailed Valuation Reports, Financial Condition Report, Bonus Recommendations, PPFM and With-Profits Governance, Individual Capital Assessment, as well as the approval of New Product launches. The Society's Internal Audit and Compliance functions also provide information to the Audit, Risk and With-Profits Committee on such matters as the Society's risk policies, FSA and other Compliance issues, and internal audit plans and reports. The Board do challenge and seek further clarification from Management if they feel it appropriate, to ensure that decision making is robust.

I have also commented on the regular meetings of the Committee of Management in paragraph 3 of the response to Question 1.

The Audit, Risk and With-Profits Committee and the Remuneration Committee receive Reports from external sources which assist in deliberations and seek to validate certain decision making processes. For example, the Remuneration Committee takes

independent professional advice to establish remuneration levels for Executive Directors and Officials for recommendation to the AGM.

I have not commented on issues relating to other businesses mentioned in the Question (wholesale banking and science-based businesses).

QUESTIONS 5 AND 6

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?

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?

It is our opinion that Non-Executive Directors should be independent, should constructively challenge management, scrutinise the performance of the Executive members of the Committee of Management in meeting agreed goals and objectives and have sufficient skills/knowledge of the sector to be able to monitor performance and make informed decisions.

The FSA does, of course, take an interest in the abilities, balance and roles of Non-Executive Directors in terms of Corporate Governance, in particular these matters are addressed in Project Arrow visits undertaken by the FSA. In addition, all of our Non-Executive Directors are Approved Persons. As mentioned earlier, Royal Liver feels that its current Non-Executive constituency has appropriate skills/competencies but we are considering where we may need to strengthen any particular areas.

The Consultation Document suggests that further changes may be implemented following the outcome of this Consultation. (Sections 3.37 to 3.40 in particular refer to Board effectiveness). Royal Liver would be interested to see the details that may emerge in this regard.

QUESTION 7

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

It is in this area that Royal Liver believes it can offer an effective and robust model that your Review may wish to consider, in terms of the influence that policyholders can bring to bear on the Committee of Management. It is, however, important to distinguish between participating in that process and running the Company. The Committee of Management, like its counterpart Board of a proprietary Company, is charged with running the Company.

You will see from the section of this response headed "Background" that Royal Liver's Members are represented by Delegates who play a pivotal role at the Society's Annual

General Meeting on behalf of the Members. I have also discussed the role of the Delegation in the section of this response headed "Governance Framework" and specifically commented on its role to scrutinise and discipline the Committee of Management in the section of this response headed "Penrose Inquiry into Equitable Life".

We feel that the Delegates hold the Committee of Management accountable for the actions and decisions it undertakes and has the ability to question those decisions at the AGM. Throughout the year, the Delegation is also provided with information on any number of issues and initiatives.

This type of policyholder representation is felt to be fairly unique in the Mutual sector but we would be pleased to participate in any discussions that you may feel would be helpful in developing this model for other parts of the Mutual sector.

QUESTION 8

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

Responsibility for the management of risk at Royal Liver is largely vested in the Audit, Risk and With-Profits Committee.

With the introduction of the PPFM, issues concerning capital investment from the With-Profits Fund are considered in detail to ensure that our policyholders are not unreasonably affected by any developments that may be made within the Society.

The Investment Strategy Group is responsible, after taking advice from various sources including Actuarial, to ensure that our solvency levels and our equity backing ratio are kept under constant review and reported to the Committee of Management on a frequent basis.

In recent times, Royal Liver has acquired a number of Companies and has used its Free Estate to fund these ventures. The approval of the Delegation was sought by the calling of a Special General Meeting. The Delegates were provided with a comprehensive package of information prior to the SGM and detailed debate relating to the various issues took place over the course of the day on which the SGM was held.

At the Society's recent AGM in May, 2004 a presentation was made to the Delegation in relation to the Society's proposed strategic direction to keep them properly informed

The Consultation Document recognises that mutuals, by their nature, have no recourse to the equity markets but rely largely on internal resources, the resources of their policyholders, to finance investments. It is hoped that you can see that Royal Liver engages its policyholders, via the Delegation, in this regard.

The Consultation Document (Section 3.19) quotes from Drake and Llewellyn to say that "the knowledge that capital cannot easily be replaced following the generation of significant losses would be likely to induce managers of mutual financial institutions to adopt a relatively low risk profile". During the course of 2003, as part of the Committee

of Management's review of solvency levels, the Investment Strategy was amended to create a lower equity backing ratio and thus adopt a more conservative and prudent approach.

QUESTION 9

Lord Penrose acknowledges that the FSA's work since 1997 "...has sought to anticipate many of the lessons that might be drawn by this inquiry and it should come as no surprise that it largely succeeded in that." (Chapter 30, Paragraph 3). Insofar as Corporate Governance is concerned, do you agree?

The FSA has conducted a number of reviews with Royal Liver over the past 2 years, including a Project Arrow visit in August, 2002, a Risk Review visit in March, 2003, and a Risk Mitigation Review in October, 2003. The Society is currently working with the FSA to manage the issues arising from these visits.

I have already commented on the improvements to the FSA's regulatory framework in paragraph 2 of the section of this response headed "Penrose Inquiry into Equitable Life" on page 3. Also, you may wish to refer to my comments in the section of this response headed "Regulation" on pages 4 and 5.

QUESTION 10

Is there a further role for the FSA to play in improving firms' Corporate Governance?

Sections 3.35 and 3.36 of the Consultation Document suggests that a number of potential changes are to be looked at in the light of this Consultation. One may be the production of a new best practice corporate governance code tailored to the specific circumstances of a mutual. The Code might include measures to increase the degree of supervision of the Executive that is undertaken by the Board or to give the Board clearer or more specific responsibilities in relation to policyholders' interests. It is stated that it might be achieved by giving additional responsibilities to the Non-Executive Directors, either individually, collectively or as a Committee.

Royal Liver considers that it already has effective and robust procedures in place, but would be interested in seeing the details of any proposals that may emerge in this regard.

QUESTION 11

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

The role of the Delegation within Royal Liver has been emphasised in various parts of this response. We feel that this body has a very important part to play on behalf of our Members and the future development of Royal Liver.

Clearly, the provision of good value products and support services are obvious market forces for Royal Liver. Our members, like all policyholders, will judge our performance in

this regard and act accordingly. The influence extended by the media and other financial commentators will also be a factor here.

It has been assumed, particularly in the light of Section 3.46 of the Consultation Document, that this Question seeks views about pressures exerted by members to demutualise. Royal Liver is committed to its mutual status and, indeed, the Delegation regularly include items on the Agenda of our Annual General Meetings to have our continued commitment confirmed. Whilst it is, therefore, to some extent, true that mutuals are not subject to the concentrated ownership influence of large shareholders, it is equally the case that Royal Liver's Delegates are, to some extent, analogous to the proprietary company situation.

QUESTIONS 12 AND 13

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

What are the forces that drive demutualisation? What are the implications of demutualisation for Members and Customers?

As a Mutual Incorporated Friendly Society, Royal Liver is limited to the type of business it can undertake. However, it can set up Subsidiaries to offer third party products through various distribution channels. 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.

As stated in the answer to Question 11, Royal Liver has no plans to demutualise. However, in common with other Mutuals, it has concerns that may need to be addressed as a result of the diminishing popularity of With-Profits business. Any proposals to demutualise would need to be referred to the Delegation at a Special General Meeting to consider if this proposed course of action is thought to be in the best interests of the Members and a decision taken to approve or reject the proposed demutualisation.

QUESTION 14

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

As I have already stated, this response is purely on behalf of Royal Liver and is not intended to reflect the views of any other Mutual organisation. It is not, therefore, felt appropriate to comment on this Question.

QUESTION 15

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

As I have already stated, this response is purely on behalf of Royal Liver and is not intended to reflect the views of any other Mutual organisation. It is not, therefore, felt appropriate to comment on this Question, save to the extent that it is worth emphasising that compliance with the complex governance requirements that may emerge will probably be disproportionately expensive for small mutuals.

QUESTION 16

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

As I have already stated, this response is purely on behalf of Royal Liver and is not intended to reflect the views of any other Mutual organisation. It is not, therefore, felt appropriate to comment on this Question.

CONCLUSION

It is hoped that you have found the information provided useful in the overall context of Corporate Governance and, more particularly, to the model operated by Royal Liver as a Mutual Incorporated Friendly Society.

It is considered that the Committee of Management of Royal Liver is as at least accountable to our Members as are the Boards of proprietary companies to their shareholders.

The level of Member involvement in our Governance arrangements via the Delegation is one in which we believe may be of much assistance to your Review and we would be pleased to offer any further support that you may require in this regard.

Yours faithfully,

Bill Connolly,
GROUP SECRETARY.