

Myners review of the governance of life mutuals

Consultation Document

July 2004



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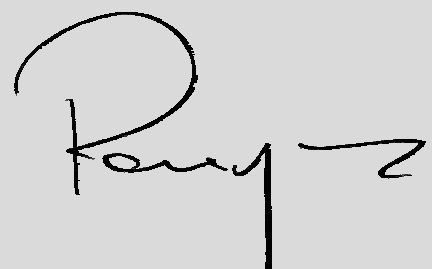
FOREWORD

Mutual life offices are a sizeable presence in the market for life insurance in the UK. They are valued by their policyholders and contribute to the diversity of the insurance sector. My challenge is to promote the very best corporate governance practice in this sector, providing a sound basis for its future health and prosperity.

My aim is to conduct this review in an open and searching way. This consultation document asks a number of questions about:

- the corporate governance guidance that applies to mutual life offices;
- the role of non-executive directors in complex businesses such as life insurance, including the information and advice that they use;
- the role of policyholders in the corporate governance of mutual life offices;
- the role of regulation in the corporate governance of mutual life offices;
- the market disciplines that influence mutual life offices;
- the potential advantages of the mutual form, particularly in the financial sector;
- general governance principles for all financial mutuals;
- the structure of the UK mutual life insurance market; and
- practice in other countries.

I very much hope that everyone who can make a contribution will engage in a dialogue with us, and help bring about proposals that will secure high standards for all.



Paul Myners

INTRODUCTION

1.1 Corporate governance is a subject that has been the focus of considerable discussion over the last 10 years. Since the initial Cadbury report¹ in 1992, Hampel, Greenbury, Turnbull and most recently Smith and Higgs have reported on various aspects of what Cadbury described as “the system by which companies are directed and controlled”.

1.2 These bodies of work are reflected in the Combined Code on Corporate Governance, published by the Financial Reporting Council, and which is annexed to the Financial Services Authority’s (FSA’s) listing rules. The rules require listed companies to make a statement on their compliance with the Code. Mutual life offices are not subject to the same obligations as regards the Code, but many choose to use the Code as a best practice guide, to the extent that it is relevant, on a voluntary basis.

1.3 In his report into Equitable Life², Lord Penrose drew attention to his view that the common understanding of corporate governance that underlies current guidance is focussed on the relationships that arise in a proprietary company, specifically the respective roles of the board of directors and shareholders, and as such “does not capture the relationships peculiar to a mutual life company and in particular the fact that, in the case of mutual with-profits business, the persons with whom business is done are the persons for whom business is done.” (chapter 9, paragraph 7).

1.4 In the light of this observation, and other findings of the Penrose Inquiry, Ruth Kelly, the Financial Secretary to the Treasury, invited Paul Myners to conduct an independent review of the corporate governance arrangements that apply to mutual life offices³.

1.5 Consistent with its terms of reference, which are reproduced at the end of this chapter, the review will not be confined to the specific issues raised by Lord Penrose in the context of Equitable Life. It is our intention to take a rounded view of all the factors that impact on the corporate governance of mutual life offices⁴, including the numerous aspects of corporate structure and culture that shape the relationship between the firm’s executive, its board and its policyholders, as well as the market, consumer and regulatory forces (including reporting and information requirements) that shape its behaviour and environment. The review’s main focus is the governance of mutual life offices, however the terms of reference also invite the review to develop general governance principles for other types of mutual, where appropriate. In doing so, it is the review’s intention to focus on the financial mutual sector. The corporate governance of co-operatives is the subject of a separate review, established by Co-operatives^{UK}. We hope to work closely with them as both reviews progress.

1.6 As part of this review, we are inviting individuals and organisations to contribute their views, and any supporting evidence, on a number of issues, summarised in the foreword.

¹ *The Financial Aspects of Corporate Governance*

² *Report of the Equitable Life Inquiry*, March 2004

³ Lord Penrose’s report and the Financial Secretary to the Treasury’s statement to Parliament on the Report are available on the Treasury’s website, www.hm-treasury.gov.uk

⁴ For the purposes of this review, we consider that all firms that conduct life business and that are constituted on a mutual basis – be it as a friendly society, an industrial and provident society, as a company limited by guarantee under the Companies Acts, or under private legislation – are within the remit of the review.

Purpose of the consultation

1.7 The purpose of the consultation is to generate ideas and evidence that can be used to review the corporate governance issues within the review's terms of reference, and to help the review team formulate proposals for possible reform.

Who is being consulted?

1.8 We are sending this consultation document to a large number of individuals and organisations, including mutual life insurers, other large financial mutuals and groups with an interest in policyholders' perspective. The review hopes that mutual life offices will take appropriate steps to ensure that as many of their policyholders as possible are made aware of this consultation. The document is available on HM Treasury's website www.hm-treasury.gov.uk/myners

1.9 We welcome comments from all interested parties, and those that feel they have a valuable perspective on the issues, not just those to whom the document has been sent.

Reporting on the results of the consultation

1.10 Once the review is complete, we will report our findings. The report will be available via HM Treasury's website. Alternatively, printed copies may be requested by writing to the address below.

Disclosure of responses

1.11 We will ensure the confidentiality of any information which respondents clearly tell us is confidential in nature. With this exception, you should be aware that all responses received may be made public unless specifically requested otherwise.

How to respond

1.12 The review team welcome written submissions by email or post. Where possible, the team would prefer submissions by email with the document attached as a Microsoft Word or pdf document. The review's addresses are:

e-mail: myners.review@hm-treasury.gov.uk

By Post: Myners Review
Room 4/16
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

1.13 General confidentiality disclaimers that often appear at the end of e-mails will be disregarded for the purposes of publishing responses unless an explicit request is made in the body of the response.

Deadline for consultation responses

1.14 Responses are requested by not later than 17 September 2004.

Issues for Consultation

1.15 A number of issues and questions on which we would appreciate your views are listed in the fourth chapter of this document. You should not confine your response to the questions if you wish to make further comments.

Context of the review

1.16 To assist you in your consideration of the questions the third chapter of this document provides some context to inform your answers.

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).

Where appropriate, bring forward recommendations to ensure that boards of mutual life offices are as accountable to their members as boards of comparable companies are to their shareholders.

As part of this, the review will examine:

- The level of member involvement in the governance of mutual life offices;
- Board accountability for mutual life offices; and
- The level of regulation by the FSA to which mutual life offices are subject.

The review will consult as widely as possible, taking into account the recent experience of other mutuals in this area in developing its conclusions and recommendations.

Since the governance of mutual life offices has much in common with that of other mutual societies, where appropriate, the review may also develop general governance principles for other types of mutual (taking into account the particular characteristics of other parts of the mutual sector).

The review will deliver a report with recommendations by the end of 2004.

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SUMMARY OF QUESTIONS

We invite your responses to the following questions. The full list of questions is to be found in chapter 4. It would be helpful if responses could highlight any innovative and practical ideas for change.

Q1. 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?

Q2. What is the best way of securing mutual life offices' compliance with corporate governance best practice?

Q3. 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?

Q4. 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?

Q5. 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?

Q6. 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?

Q7. What role should policyholders play in the running of mutual life companies? Are there practical barriers to policyholder participation in UK life mutuals? What action would be needed to allow more effective engagement?

Q8. 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?

Q9. Lord Penrose acknowledges that the FSA's work since 1997 "...has sought to anticipate many of the lessons that might be drawn by this inquiry, and it should come as no surprise that it has largely succeeded in that." (chapter 30, paragraph 3). In so far as corporate governance is concerned, do you agree?

Q10. Is there a further role for the FSA to play in improving firms' corporate governance?

Q11. 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?

Q12. Do specific barriers exist to the success of mutual businesses in the UK? If so, how might they be addressed?

Q13. What are the forces that drive de-mutualisation? What are the implications of de-mutualisation for members and customers?

Q14. 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?

Q15. Do small, affinity group-based, mutual life firms face different governance issues from the largest firms in the sector?

Q16. 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?

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THE CONTEXT OF THE REVIEW

3.1 To assist your consideration of the issues raised in this consultation document, there follows a brief summary of the relevant findings of the Penrose Inquiry into Equitable Life, some broader perspectives on the governance issues facing mutual life offices, a summary of recent developments and a brief overview of potential measures that might be taken to address the issues identified.

THE FINDINGS OF THE PENROSE INQUIRY INTO EQUITABLE LIFE

3.2 In his report Lord Penrose exposes a number of lessons to be learned from the events at Equitable Life, which is among the largest mutual life offices in the UK. In doing so he is clear that, while some of the specific issues he addresses are peculiar to past events at Equitable Life:

“There is, however, nothing in the structure of a mutual life office to prevent a similar problem emerging.” (chapter 9, paragraph 196).

3.3 There was, in his view, ineffective scrutiny and challenge of the executive of the Society:

“The critical responsibilities for valuing liabilities, assessing the liability implications of new products, and identifying and monitoring risk generally were discharged by a discrete part of the organisation that was not subject to effective scrutiny or challenge.” (chapter 20, paragraph 50)

3.4 The report highlights the characteristics of Equitable’s Board during the period covered by the inquiry, noting that at critical points in the Society’s history it:

“...had insufficient knowledge and skills to provide an effective challenge to the executive in critical areas.” (chapter 19, paragraph 240).

As a consequence:

“...the Board’s dependence on actuarial advice was total. None of the non-executive directors had relevant life office experience or relevant qualifications.” (chapter 9, paragraph 30).

More specifically:

“None of the non-executive members of the Board had relevant skills or experience of actuarial principles or methodologies.” (chapter 19, paragraph 89).

3.5 The Board also failed, according to Lord Penrose, to put in place appropriate mechanisms to see that it had the information and advice to exercise its responsibilities:

“The Board relied on reports made directly to them by the Society’s senior actuarial staff...without instituting and maintaining any committee system to consider in detail and report on actuarial management.”(chapter 19, paragraph 104).

As a consequence:

“...the Board was never fully advised of the financial implications of the decisions that were said to be open to them.” (chapter 19, paragraph 84).

3.6 He also raises interesting questions about the relationship between the Board and specialist members of the executive, as well as 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:

“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. Equitable’s non-executive directors were so wholly dependent on actuarial input from the executive and in particular from the chief executive/actuary that they were largely incapable of exercising any influence on the actuarial management of the society.” (chapter 20, paragraph 50).

He reports that Equitable’s own non-executives made the point that:

“...as generalist non-executive directors, the individuals in question were incapable of addressing independently such fundamental aspects of the firm’s business as its actuarial management and liability valuation.” (chapter 20, paragraph 53).

3.7 The report also asserts that the Board itself was not subject to effective external scrutiny or discipline. In doing so, it compares the situation of mutual life offices with the position of proprietary firms:

“In the case of proprietary firms, the primary responsibility for the selection of directors and calling the board to account for its direction of the business must continue to rest with the shareholders of the company, whose capital stands at risk in the event of mis-management. However, the position is different for a mutual like Equitable, where it is the policyholders who are the source of the risk capital for the enterprise.” (chapter 20, paragraph 51).

3.8 Although they were the owners of the Society, it was difficult for policyholders to call the board to account:

“Under the Society’s articles policyholders were effectively powerless, and the Board was a self-perpetuating oligarchy amenable to policyholder pressure only at its discretion.” (chapter 20, paragraph 51).

Contributing to the problem was the complexity of policyholders’ relationship with Equitable Life. Not all policyholders were members, and their status as members could change over time:

“...the relationship between the members and the company is unique. A basic characteristic of mutual business is the identification of membership of the company with the contractual relationship between the holders of participating contracts and the office already mentioned. Membership is typically defined in terms of participation in the profits of the distributable surplus of the office. Non-participating contracts, for example a fully guaranteed policy providing a fixed obligation to pay a specified sum of money on a contingency, and linked contracts may not qualify the policyholder for membership. 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 documents of the office by reference to those policies. This makes the application of common rules and principles of governance difficult.” (chapter 9, paragraph 13).

3.9 Lord Penrose acknowledges that the FSA's work since 1997:

"...has sought to anticipate many of the lessons that might be drawn by this inquiry, and it should come as no surprise that it has largely succeeded in that." (chapter 20, paragraph 3).

For details of some of the specific actions taken, see paragraphs 3.25 to 3.29.

3.10 He nonetheless envisages some further scope for the FSA to be involved in improving the effectiveness of the boards of life mutuals. In particular he suggests the

"FSA consider how their powers may be exercised to address the problem of unbalanced or ineffective boards."

Adding that:

"...the regulators should be confident that where necessary they are able to require changes to the board to address major gaps or imbalances in directors' collective skills or experience." (chapter 20, paragraph 52).

3.11 Lord Penrose identifies a need to improve participation by policyholders, but sees:

"...no ready means by which regulators could force the remaining mutuals to adopt articles that facilitated policyholder action" (chapter 20, paragraph 54).

3.12 He speculates that, to protect policyholders' interests, the FSA's role might be extended:

"...it might be acceptable for the regulator to have power to appoint from a panel of experts an adviser to the board of a life office in case of need, with access to all board papers and to the board itself, and with power to report to FSA on management. This would fall short of the formal appointment of an independent reporter. It could be more flexible. And if it failed to produce results FSA's subsequent formal action would be facilitated. A power to report to FSA rather than an obligation would improve the prospects of acceptance of the adviser as a source of support to the board rather than a threat to current management. An occasion for the appointment of such an adviser would be recognition of a risk that the firm might be in danger of failing in its obligation to treat policyholders fairly." (chapter 20, paragraph 55).

Though he recognises that:

"There would be resistance to direct involvement of regulation in management for understandable reasons." (chapter 20, paragraph 55).

OTHER PERSPECTIVES ON THE GOVERNANCE OF LIFE MUTUALS

3.13 Lord Penrose's inquiry was largely confined to the particular circumstances of Equitable Life, but some of the specific governance issues he raised have also been examined in other quarters. In particular, there is an ample and informative body of academic literature on various aspects of corporate governance, including the governance of financial mutuals. The paragraphs that follow seek to give a flavour of some of the thinking to be found in that literature.

The differences between mutuals and proprietary companies – and what this means for their corporate governance

3.14 The main difference between a mutual life insurer and a proprietary life insurer is, of course, the ownership structure. Shareholders own proprietary companies. Mutuals are owned by their customers. This has a number of important consequences.

3.15 In proprietary companies a tension exists between the interests of the owners of the business and the interests of its customers. Mutuals do not experience this tension to the same extent, because being a customer may confer ownership rights. (It is worth noting, however, that not all policyholders of mutual life companies will necessarily have membership rights, and the interests of different groups of policyholders may differ.) This bringing together of ownership and customer interests can be a particular advantage in the case of a life insurance company, as O’Sullivan and Diacon¹ explain :

“...since many insurance contracts are long-term in nature, policyholders have a special interest in ensuring that the insurance company maintains sufficient reserves to pay out on policies when claims are made. The existence of shareholders in proprietary insurance companies – who are not necessarily policyholders – introduces the possibility that wealth-enhancing policies for shareholders may undermine the company’s ability to satisfy future claims from policyholders. A solution for policyholders is to adopt the mutual form –whereby the functions of owner and policyholder are merged and the possibility of shareholder/policyholder conflict eliminated.”

3.16 A proprietary company, by contrast, will tend to be better able to control the tensions that exist between owners and managers - that is, the extent to which management might pursue its own interests at the expense of the owners of the firm. O’Sullivan and Diacon describe the issue for mutual offices in the following way:

“The absence of shareholders eliminates two important sources of ownership control: the threat of takeover and the ability to discipline ineffective management, and the potential for individual shareholders to acquire a significant share of the company’s equity and thereby possess both the incentive and ability to actively monitor management behaviour.”

The differences between life mutuals and other financial mutuals – and what this means for their corporate governance

3.17 Drake and Llewellyn² argue that although mutual owners have limited means of directly influencing decision-takers, in the building society sector they can do so through alternative control mechanisms:

“In mutual organisations, depositors/owners typically exhibit little member voice...but rather can exercise the easy and costless option of exit. In other words, it is easier and less costly for a member simply to (almost costlessly) withdraw business (e.g. a deposit) and transfer it to a competitor than to seek to change the behaviour of the firm. This is a powerful discipline and is in some senses a more

¹ *Internal and External Corporate Governance Mechanisms: evidence from the UK insurance industry*; Noel O’Sullivan and Stephen R Diacon, 1999

² *The Economics of Mutuality*, Leigh Drake and David T Llewellyn in *The New Mutualism in Public Policy*, Ed Johnston Birchall, 2001

direct threat to the managers since...when a depositor withdraws funds, the capacity of the mutual is immediately reduced, whereas the sale of an equity stake in a plc does not immediately influence the capacity of the firm though the share price might fall.”

3.18 This suggests that the specific problems associated with the absence of shareholder discipline and the threat of takeover might be counterbalanced – or at least mitigated – in financial mutuals. This discipline is at its most effective when the mutual offers products where performance is easily understood, and exit is easily and cheaply achieved, such as those typically provided by building societies. The same is not typical of mutual life offices, which tend to offer longer-term, more opaque products, where performance can be difficult to gauge and where exit can be more costly and difficult.

3.19 A further important difference between mutuals and proprietary companies is their relative ability to access capital. Proprietary companies have access to external sources of capital, from the equity and the debt markets. Mutuals by their nature have no recourse to the equity markets and tend to have only limited external debt, but instead rely largely on internal resources – the resources of their policyholders - to finance investments. In theory this should influence their choice of business strategy, as Drake and Llewellyn explain:

“...mutual financial institutions tend on the whole to be highly specialised and relatively low-risk institutions, with the mortgage and life assurance markets providing prime examples...With respect to risk, this reflects the fundamental characteristic of mutuals; specifically their lack of access to significant external sources of capital via specialist risk-takers. 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.”

The potential advantages of financial mutuals

3.20 The academic literature suggests that, at least in theory, financial mutuals may enjoy certain efficiency advantages. For example, Drake and Llewellyn conclude that:

“There are sound economic reasons why mutual financial institutions emerged in certain areas of the financial services market place. These are associated with the intrinsic efficiency advantage of mutuals (by virtue of not having to service an additional stakeholder (shareholder), and the greater ability of financial, as opposed to non-financial, mutuals to mitigate the agency problems which potentially occur in any large organisation characterised by the separation of risk-bearing and decision-making functions.”

3.21 A Swiss Re study³ argues that regulation has diminished the historical advantage of the mutual form:

“Regulation, like mutual ownership, reduces the costs of contracting between an insurer and its policyholders. By constraining the behaviour of insurers, regulation improves the credibility of their long term contracts, thereby making it easier for stock companies to compete.”

³ *Are mutual insurers an endangered species?* Swiss Re, Sigma No. 4/1999

The study nonetheless concludes that:

“The substantial market presence of mutual insurers around the world strongly suggests that they possess certain fundamental competitive strengths.”

It attributes this to their efficiency of operations and the advantages they derive from their mutual ownership structure.

3.22 In a submission to the Treasury Select Committee⁴, David Llewellyn argues however that:

“...the case for retaining a mutual sector in the financial system is not that mutuals are inherently superior to plcs, but that there is a systemic interest in diversity in the financial system.”

This is because:

“There is a powerful systemic interest in having a mixed ownership structure and sustaining a strong mutual sector both in terms of competition and the overall risk characteristics of the financial system.”

THE ROLE OF THE FSA

3.23 Under the Financial Services and Markets Act 2000 (FSMA) the FSA has a range of statutory powers it can exercise that may influence firms’ corporate governance. The focus of FSA regulation is the authorised firm. A condition for authorisation is that the firm meets the threshold conditions set out in the FSMA, which include requirements for the firm concerned to have adequate resources and for it to be a fit and proper person to carry out regulated activities. The adequacy of the governance arrangements, including the suitability of the board and senior management are central to that assessment. In addition, the FSA has powers to make statements of principle. These include the power to make statements of principle and to set a code of practice with respect to the conduct expected of board members of the firms it authorises, and the “fit and proper” test, which gives the FSA the power to assess the fitness and propriety of candidates for authorised firms’ boards and other senior management positions. The FSA also has information gathering powers that may have a bearing on corporate governance. For example the FSA may require the appointment, by an authorised firm, of skilled persons to carry out an investigation and to report on certain matters to the firm (Section 166). The FSA may also appoint persons to conduct an investigation of an authorised firm on the FSA’s behalf (Section 167).

3.24 Relevant rules and guidance in the FSA’s Handbook include the requirements that firms must treat their customers fairly, and manage conflicts of interest fairly. Firms must take reasonable care to maintain a clear and appropriate apportionment of significant responsibilities among directors and senior managers. Firms are also subject to systems and controls requirements and rules relating to regulatory returns and financial reporting.

⁴ Memorandum from Professor David Llewellyn, Professor of Money and Banking, Loughborough University, 1999

RECENT DEVELOPMENTS

FSA regulation

3.25 A number of changes to the FSA rules have been made, or have been proposed⁵, that will have implications for the governance arrangements of all with-profits business. These have the aim of making the use of discretion in with-profits funds more transparent as well as making directors and senior management of life insurers explicitly responsible for all decisions of their business, including those taken on actuarial advice.

3.26 Of particular relevance to this review is the requirement that firms must publish and make available a statement of their Principles and Practices of Financial Management (PPFM) that they apply 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 whether, and how, the firm has complied with its PPFM obligations. The PPFM covers such issues as:

- the firm's approach to setting annual and final bonus rates and “smoothing” the value of with-profits contracts;
- its investment strategy for with-profits business;
- the management of any inherited estate and the uses to which this may be put; and
- its approach to achieving a balance between the interests of with-profits policyholders and the interests of any shareholders of the firm.

The first PPFMs had to be published by the end of April 2004.

3.27 Other changes, for all life insurers, include replacing the role currently fulfilled by the Appointed Actuary so that boards and senior management demonstrably take overall responsibility for the actuarial aspects of the business. Two new advisory functions will be introduced at the end of 2004. The first, the actuarial function, will apply to all life firms and his/her role will include advising the board on the valuation of policyholders' liabilities. The second, the with-profits actuary, will apply only to with-profits firms and his/her role will include advising the firm on key aspects involving the use of discretion within its with-profits fund. The Morris Review of the Actuarial Profession's recent consultation document⁶ provides a summary of these reforms and asks a number of questions about the Appointed Actuary regime and its planned replacement.

3.28 The FSA's new rules also address the concentration of influence seen in the board of Equitable Life by preventing the individuals holding the two new actuarial posts from also being Chairman or Chief Executive, or holding any other role that involves a conflict of interest. The with-profits actuary also cannot be a member of the board.

⁵ CP167, *With-profits governance, the role of actuaries in life insurers, and certification of insurance returns*, published in January 2003 and CP207, *Treating with-profits policyholders fairly*, published in December 2003

⁶ *Morris Review of the Actuarial Profession: A Consultation Document*, published June 2004

3.29 Independent scrutiny will be enhanced through widening the scope of the audit review to cover aspects of the regulatory return that are currently the responsibility of the Appointed Actuary. As part of their work auditors of life firms will be required to obtain advice from an actuary who is independent of the firm, and of the firm's actuary, on all actuarial aspects of the balance sheet. The reviewing actuary will be required to provide a public opinion. The audit report will also explicitly refer to the fact that a suitably qualified independent reviewing actuary has been consulted.

Corporate governance guidance

3.30 Thinking on corporate governance and the guidance that has been derived from it, has evolved considerably during and since the period covered by Lord Penrose's Inquiry (which looked at events at Equitable Life from the 1950s until August 2001).

3.31 The first version of the Combined Code was issued by the Hampel Committee on Corporate Governance in 1998. It was replaced by a new Code issued in July 2003, which derives from a review of the role and effectiveness of non-executive directors by Sir Derek Higgs⁷ and a review of audit committees by a group led by Sir Robert Smith⁸.

3.32 The Higgs report recommended changes to the Combined Code to require a greater proportion of independent, better-informed individuals on the board. It recommended changes to require greater transparency and accountability in the boardroom, formal performance appraisal, and closer relationships between non-executive directors and shareholders. It also called for all boards to put in place more structured appointments and succession planning processes.

3.33 The Smith report set out the key elements of the audit committee's role, with the particular aims of reinforcing the auditor's independence and maintaining the integrity of the company's financial statements. Specific recommendations included increased transparency and resources for the audit committee.

WHAT FURTHER CHANGES ARE CALLED FOR?

3.34 The review will be exploring all of the issues set out above and, in the light of its findings and responses to this consultation, will be looking closely at a range of possible changes. The following paragraphs set out some of the areas that we are likely to cover, with a view to presenting a package of recommendations in the review's final report.

Corporate governance guidance

3.35 A number of potential changes could be made with the aim of supporting mutual life offices' boards. They might include, for example, producing a new best practice corporate governance code that is tailored to the specific circumstances of the mutual life sector. In particular, 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. As noted in the introduction, adherence to the Combined Code is currently entirely voluntary for life mutuals. The new code might be made more binding.

⁷ *Review of the role and effectiveness of non-executive directors*, published January 2003

⁸ *Audit Committees Combined Code Guidance*, published January 2003

3.36 Such a code might include measures designed 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. This might be achieved, for example, by giving additional responsibilities to the non-executives (either individually, collectively or as a committee).

Board effectiveness

3.37 Boards' effectiveness might be enhanced through a more systematic approach to board construction. For example, by offering guidance to boards on the mix of qualities and characteristics their directors collectively should have (perhaps in the context of a sector-specific corporate governance code).

3.38 In recognition of the highly technical nature of the business of life offices, the review will be assessing what role non-executives can realistically be expected to play in such organisations or in other similarly complex types of business.

3.39 We will also be assessing whether changes are needed to help ensure that non-executive directors have access to the right training, information and advice, including access to independent advice.

3.40 Such measures might be complemented by steps to enhance the external disciplines on the board. This might be facilitated by greater disclosure. For example, independent directors might be asked to certify that they had received appropriate advice and had been able to secure independent support in pursuit of their understanding of the business.

Policyholder voice

3.41 Some life mutuals have actively taken steps to facilitate their members' involvement in the running of the office. Others are less pro-active. The review will be exploring ways in which best practice might be promoted in this respect.

3.42 Specific areas of interest are to examine what scope there might be to improve participation through:

- Facilitating voting by policyholders at general meetings;
- Ensuring that policyholders have ready access to a register of their office's membership; and
- The dissemination of timely and relevant information to policyholders.

3.43 Large shareholders in listed companies are a source of concentrated and well-resourced influence on their boards. We will be exploring what ways there may be of promoting influence of this kind in the mutual sector. We will, in particular, be looking at what ways there may be of promoting dialogue between a firm and its owners over its strategic direction. Clearer disclosure to policyholders of the risks inherent in company strategies and what they mean for policyholders' interests might be a way of achieving this.

Regulation

3.44 The review will be giving careful consideration to the specific ideas generated in Lord Penrose's report (outlined in paragraphs 3.10 to 3.12 above) that involve the FSA. In doing so, it will take into account how those ideas might impact on the FSA's role, as well as considering what other responses to the issues raised by Lord Penrose - regulatory or otherwise - might be appropriate.

3.45 As noted elsewhere in the consultation document, the review will be examining what role disclosure of information might play in improving corporate governance. This might involve, where appropriate, building on or refining the existing regulatory disclosure regimes.

Market disciplines

3.46 While mutuals are subject to a range of disciplines, including the disciplines of the competitive market place and the threat of members' resolutions to promote demutualisation, the absence of shareholders means they are not subject to the market discipline of the threat of takeover, or the concentrated ownership influence of large shareholders.

3.47 In the light of this, the review is interested to consider possible ways of enhancing the external disciplines on mutual life offices. Disclosure of information could be a powerful tool in this context. For example information that more fully explains the performance of each mutual life office (such as the maturity and surrender values of certain sample policy types) might be made available to policyholders, market commentators or to other agencies.

4

MAIN QUESTIONS

WE INVITE YOUR RESPONSES TO THE FOLLOWING QUESTIONS:

Corporate governance guidance

Q1. 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?

We would welcome information on the extent to which mutual life offices currently comply with the Code.

In what ways might a new code be tailored to better suit the circumstances of mutual life offices? It would be helpful if you could identify any specific aspects of the current guidance that you consider are either not relevant to or inappropriate for mutual life offices as well as any additional measures that you think would be more suited to the mutual life form.

We would particularly welcome your perspective on the relevance to mutual life offices of the “comply or explain” principle in the Code. The principle, which is designed for public limited companies, has at its foundation the existence of an on-going dialogue between the company and its shareholders. How relevant is it to the different circumstances of the mutual life sector?

We would welcome innovative thoughts on how the “comply or explain” principle might be made more effective for mutual life offices, for example through fostering a more meaningful dialogue with policyholders or their representatives. Alternatively, should it be replaced?

Q2. What is the best way of securing mutual life offices’ compliance with corporate governance best practice?

As noted in the introduction, listed companies are required by the listing rules to make a statement on their compliance with the Combined Code. No such arrangement currently exists for mutual life offices, whose adherence to the code is entirely voluntary. In what ways might current or any new guidance be made more binding?

Board effectiveness

Q3. 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?

In particular:

- Does it have any implications for the balance on the board between executives and non-executive directors?
- How important is it that the non-executive directors of life mutuals should possess specialist knowledge? What specific types of knowledge are most relevant to the conduct of life business in a mutual ownership framework? In what ways might life mutuals establish the relevance of candidates' knowledge and see that it is kept up to date?
- What board committee structure do you consider to be effective? Is there a case for any new or different type of committee?

We would welcome any examples you may have of good practice as well as ideas on how best to achieve the desired outcomes.

Q4. 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?

What factors determine the quality and relevance of the information and advice used by the non-executives of mutual life offices?

What role might use of external information and advice play in better equipping the non-executives of mutual life offices to perform their duties?

In its recent consultation document¹, the Morris review of the Actuarial Profession looks at specific issues surrounding the FSA's plans to re-define the role of actuaries within life offices (particularly plans to replace the role of appointed actuary with new actuarial roles) and whether non-executive directors have sufficient expertise and information to challenge actuarial calculations. This review is concerned with all of the responsibilities of the board of a life mutual, including oversight of the actuarial function.

¹ *Morris Review of the Actuarial Profession: A Consultation Document*, published June 2004

Q5. 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?

And

Q6. 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?

The Penrose report highlights the practical challenges faced by non-specialist non-executive directors in overseeing technically complex aspects of the life insurance business. How are these challenges met in your experience? Are there some specific areas of business that are more challenging than others? Do similar considerations apply in other businesses?

Policyholder voice

Q7. What role should policyholders play in the running of mutual life companies? Are there practical barriers to policyholder participation in UK life mutuals? What action would be needed to allow more effective engagement?

In what ways are policyholders currently engaged? Do you have any practical suggestions on how we could achieve a better dialogue between life mutuals and their owners across the sector? Is there a role for better disclosure of information? We would particularly welcome any examples of good practice that you can provide.

It would be helpful if you could also consider what the consequences would be of increasing policyholder involvement. In particular, what checks and balances would there be against narrow policyholder interests prevailing to the potential detriment of the interests of other groups of policyholders? It is worth noting that not all policyholders share the same interests – different types of policyholders may have different objectives for the company – and not all policyholders are voting members of life mutuals (for example investors in unit linked funds and annuitants may not be members).

What role should the board play in ensuring equity between different groups of policyholders?

Is there a role for other organisations or groups to act on policyholders' behalf? If so, what organisations or groups would be best suited to such a role?

Q8. 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?

What implications does the mutual form have for the way in which a firm conducts life business? For example, should mutual life offices be more risk averse than their proprietary counterparts? Is there evidence that they are more risk averse?

What information is supplied to policyholders on the business strategies of their offices?

In what ways are policyholders made aware of the risks attached to the strategic decisions of their Boards? What account is taken by boards of policyholders’ attitude to risk?

Regulation

Q9. Lord Penrose acknowledges that the FSA’s work since 1997 “...has sought to anticipate many of the lessons that might be drawn by this inquiry and it should come as no surprise that it has largely succeeded in that.” (chapter 30 paragraph 3). In so far as corporate governance is concerned do you agree?

In what ways, in your experience, is supervision by the FSA currently concerned with mutual life offices’ corporate governance? How effective are the instruments currently at its disposal?

Q10. Is there a further role for the FSA to play in improving firms’ corporate governance?

If so, what form might this take, and what would the practical consequences be? In particular, what safeguards would exist to ensure that, in doing so, a proper distinction remained between the responsibilities of the FSA as a regulator and the responsibilities of the life mutual’s own board?

Market disciplines

Q11. 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?

What scope is there to enhance the external disciplines on mutual life offices? For example, can you think of a body or group that might behave in a similar fashion to the large shareholders of a public limited company?

Could more independent monitoring of life mutuals have a role to play? If so, by whom? What information might they need to perform this function?

We would welcome innovative and practical ideas.

The potential advantages of financial mutuals

Q12. Do specific barriers exist to the success of mutual businesses in the UK? If so, how might they be addressed?

And

Q13. What are the forces that drive de-mutualisation? What are the implications of de-mutualisation for members and customers?

Theory suggests that financial mutuals should enjoy certain inherent advantages. Consistent with this, some individual mutual businesses have enjoyed notable success. Nonetheless empirical evidence suggests that overall the main trend in the UK is towards de-mutualisation. In the UK, some 12 major life insurers have demutualised since 1990. A similar trend has been observed in the US as well as in Canada, South Africa and Australia, though the same is not the case in most other European countries. Why, in your view, is this the case?

What competitive or other business advantages does mutuality confer? Do you consider that particular types of financial sector business lend themselves to mutual ownership structures?

In your view, what new business opportunities exist for mutually owned businesses in the financial sector? What, if any, are the barriers to these opportunities being exploited?

What are the practical consequences of de-mutualisation, particularly for the interests of the firms' members and their customers?

General governance principles for financial mutuals

Q14. 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? Whichif any of the options for life mutuals could be applied more widely in the financial mutual sector? What would the consequences be?

The review's terms of reference give it the task of considering what general governance principles might be applied to other types of mutual. We would, in particular, welcome information on any governance arrangements that are specific to other types of financial mutual, as well as your views on whether any of the generic options outlined in paragraphs 3.34 to 3.47 of this document might have some relevance to those mutuals.

Market structure

Q15. Do small, affinity group based, mutual life firms face different governance issues from the largest firms in the sector?

The UK life market is the largest in Europe and the third largest in the world, with total premiums of £35bn in 2003-04². Although a number of large mutual insurers converted to stock ownership in the 1990s, mutuals still account for a significant proportion of UK life business and include four of the top twenty life offices by total UK net premiums in 2002. At the same time, the mutual life sector contains many much smaller firms that are often based on particular affinity groups.

In your view, is governance inherently stronger in firms of a certain size or with a certain policyholder base? It would be helpful if you could provide specific examples to illustrate your response.

Practice in other countries

Q16. Are you aware of effective governance regimes for life (or other) mutuals in other countries? Is this the result of a formal (regulatory or government) requirement or is it voluntary driven by the industry? Are there aspects of the arrangements in other countries that it would be desirable and practical to adopt in the UK?

We are interested to know to what extent the UK differs from other countries in terms of the governance of its mutual life firms. While the principles of governance of stock companies are broadly similar across the OECD, it is less clear whether there are separate governance requirements for life or other mutuals either in addition to or instead of the arrangements for stock companies. We would welcome any examples from overseas from which we might learn.

Are you aware of any specific examples of good practice among individual mutual organisations overseas?

² source ABI, (www.abi.org.uk)

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