

**Myners review of the governance of life mutuals – Consultation Document –  
The Requested Comments of Allen Sykes**

10<sup>th</sup> September 2004

**INTRODUCTION**

The background to my comments are the analyses set out in my and Bob Monks' earlier publications<sup>1</sup>. The essence of these publications is that quoted companies need effective, knowledgeable, committed, long-term owners to hold corporate managements effectively accountable to the long-term interests of owners. Both publications show the strong evidence that such companies significantly outperform less well-governed companies. Additional widespread international research in the last two years is virtually conclusive on this point. They also showed that companies run in the long-term interests of their owners optimised the position of all their main stakeholders as well, particularly customers and employees.

The obvious problem for mutual companies, as frequently commented on in the Consultation Document, is that there are no conventional shareholders. Instead they are owned by their customers – the policyholders in the case of Life Mutuals. This used to work satisfactorily until recent years but there have been some notable

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<sup>1</sup> 1 'CAPITALISM FOR TOMORROW – Reuniting Ownership and Control – by Allen Sykes, Capstone 2000; and

2 'CAPITALISM WITHOUT OWNERS WILL FAIL – A Policymaker's Guide to Reform' with Robert Monks – published by the Centre for the Study of Financial Innovation (CSFI) in London and New York, November 2002.

Copies of both publications are available on request.

casualties, and particularly Equitable Life. There has also been strong financial presence by policyholders in numerous companies to demutualise – a pressure which may well increase because of the often significant short-term financial benefits which flow to the current policyholders.

The main governance problem for conventional public companies arises because the individual shareholders (15% on average) and the beneficial shareholders (most of the rest) are in practice virtually powerless to defend their interests effectively. Their main agents, the pension fund trustees and life insurance companies, together with their fund managers, are subject to serious conflicts of interest. All the agents largely depend on corporate patronage for business, and are poorly placed to hold their paymasters accountable to their beneficiaries' interests. (See especially pages 9 to 15 of our recent CSFI publication.) The individual and beneficial shareholders are so small relatively to either the investment institutions or corporate managements that it is not in their *individual* self-interest to spend their time and money trying to secure a better deal for themselves. Only if they could mobilise collectively could they look after their interests – and there is no present mechanism to achieve this. Equally, their agents, the investment institutions, have no ability *or compulsion* to act collectively save in a corporate crisis by when it is normally too late to protect shareholder value. Individual shareholders, beneficial shareholders, and the investment institutions all suffer from the inability to act collectively and hence effectively. As is fairly well understood in mainstream economics thanks to the pioneering work of Mancur Olsen<sup>2</sup> - albeit little anywhere else – effective collective action from which all would benefit requires an *external* catalyst. The participants are

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<sup>2</sup> See 'The Logic of Collective Action' by Mancur Olsen, Harvard University Press 1965 and 1971 – commented upon at length in our CSFI publication.

quite powerless to remedy the situation themselves, and market forces are equally powerless – two of the great insights of Mancur Olsen. The external catalyst can usually only come from government or some strong regulatory body such as a main stock exchange.

In the case of conventional companies the prime solution is the enforcement of *existing* trust law on all pension fund trustees and other investment fiduciaries – see our CSFI publication (pages 30 to 36). This would lead, *inter alia*, to the appointment of some powerful independent non-executive directors directly nominated and elected by shareholders to get accountability into the heart of every boardroom.

The challenge for the Myners Report is how the fundamental remedies for publicly quoted corporations can be adapted to the Life Mutuals. With the owners being the hundreds of thousands of individual small policyholders Life Mutuals are in effect companies with no institutional shareholders – only individual shareholders. Such shareholders have no means of being influential. Further, the reforms that would work for quoted companies – ensuring that trustees and fiduciaries obey *existing* trust law - would not help them.

## **THE SOLUTION IN OUTLINE**

As I set out in my book – page 58 – the essence of any system of governance is that those to whom major powers are entrusted must be accountable to those whom they serve. Otherwise self-interest takes over. The prime requirement on every corporate management and their directors is therefore that they should be held accountable to

the long-term interests of those whom they serve. In the case of Life Mutuals it will be obvious that it has to be the *long-term* interests of the policyholders because life insurance is a very long-term business. Indeed the interests to be maximised must by their nature be the longest-term interests of any industry.

It is also clear, however, as set out in Section 3.8 of the Consultative Document, quoting from Lord Penrose's Report, that Equitable's policyholders '...were effectively powerless, and the Board was a self-perpetuating oligarchy answerable to policyholder pressure only at its discretion.' (Much the same applies to all Life Mutuals as far as I am aware.) In such a situation, with few effective checks and balances (most of which are external – e.g. government and regulators) the temptations to self-interest are often irresistible. When managements have the power to enrich themselves without achieving exceptional performance – a clear sign that market forces have partly or largely broken down – they come to regard their performance, whatever it is within reason, as fully deserving increasingly higher and unearned rewards. Add in non-executive directors effectively chosen by such managements (i.e. the monitored choosing the monitors) and who frequently lack the necessary expertise – an oft repeated observation in the Penrose Report – and who certainly lack the incentive to rein back and hold accountable the very managements who appointed them – then the stage is dangerously set for an unsatisfactory outcome. Policyholders have to rely on largely inexpert non-executive directors to show great strength of character, to do so continuously over long periods, and somehow to exercise effective expert oversight over their nominators and paymasters. It is asking much, often too much.

The solution can clearly be identified in principle. There has to be some objective independent mechanism for appointing a sufficient quorum of independent non-executive directors. They must either have the necessary expertise for the life insurance industry, or have *separate* expert advice. Nothing less would hold managements accountable and so protect policyholders. As Bob Monks has frequently pointed out in similar circumstances self-perpetuating boards cannot appoint *independent* directors. It is a *non sequitur*. There is a clear and unbridgeable conflict of interest.

I do not have sufficient knowledge of the life insurance industry to specify in detail how best to ensure independently appointed directors, but the principle is clear. If it is accepted then others are better placed to work out the practical detail.

In the light of the above reasoning I turn to answering the questions on which I have been particularly asked for comments.

### **MY RESPONSE TO KEY QUESTIONS POSED**

**Q3 'Should the ownership structure or the nature of a life mutual affect the corporation or structure of its board, and if so, how?'**

The answer must be 'yes'. The board must be responsible to the long-term, the *very long-term* interests of all its policyholders, and to be able to resolve conflicts of interest which exist or may arise between different groups of policyholders (a

seeming failure of the board of Equitable Life). This inescapably requires that most (perhaps all) of the non-executives must:

- (i) be appointed quite independently of management by some mechanism of a trustee nature on behalf of policyholders;
- (ii) they need to be quite long-term appointments (6 years plus – perhaps longer – subject to checks and balances);
- (iii) they must have some relevant expertise, and if not fully expert (unlikely) they must be competent to appraise expert advice; and
- (iv) they must be separately advised by competent expert third parties wholly independent of management.

As to 'how?' perhaps some relevant trade association, the Institute of Actuaries, a Government regulator or some combination of the above, must produce a panel of competent non-executive director candidates – and, quite separately – a panel of independent qualified experts to advise them. This latter group could be paid by the Life Mutual on a tariff agreed by the Regulator.

The non-executive directors would need to be voted on by policyholders in some appropriate way. Perhaps special purpose trust companies could compete to advise policyholders – paid for by the Life Mutual. This needs most careful thought.

The non-executive directors need decent remuneration for theirs is a responsible and risky job. Further, their liabilities need to be capped in some way (3 times average remuneration of the last 3 years?) if competent candidates are to come forward.

The non- executive directors, advised by the group who chose them (and the qualified experts) should appoint the independent experts from the candidate group.

**Q4 How can the information and advice to non-executive directors be improved?**

See answer to Q3.

**Q4 (continued) Do similar issues arise in other complex businesses?**

Yes – and they are the hardest type of business to recruit sufficiently expert non-executive directors. The solution is to choose highly able *generalists*, able to probe expert opinion – and preferably to give the non-executives access to separate advice to avoid conflicts of interest. This has not often happened to date to my knowledge but I believe it will increasingly be the case in future as the litigation risks increase for non-executive directors in such businesses.

**Q5 What is the role of a non-executive director in a complex business, and their capacity to understand and challenge management on background matters?**

At present most non-executives seem to lack sufficient technical knowledge to hold managements fully accountable – but it is necessary to hold them accountable. The only solution – see answer to Q3 above – is competent generalists, independently advised by competent experts.

**Q6 (i) What can owners of complex businesses reasonably expect of their non-executives?**

That shareholders either appoint them directly (unsuitable and unworkable for a myriad of small policyholders) or they are independently appointed by competent, independent 'trustee' type institutions on their behalf. See answers to Q3 and Q4 above.

**Q6 (ii) How would you characterise the practical limitations of a non-executive director?**

Unaided by expert, objective, independent advisers they cannot discharge their onerous responsibilities adequately. In such businesses, they run high risks to reputation and face potentially penal litigation. Unless helped, the supply of good candidates will fall significantly and may dry up in a few years.

**Q6 (iii) What steps might be taken to codify what is reasonable and realistic?**

See answer to Q3 above.

**Q6 (iv) Should executives and non-executives have the same legal duties to the company?**

They must continue to share the duty of always working in the best interests of the company (mainly its shareholders) but the non-executives have the additional duty of

monitoring the executives. The law should be made clear in this point. It follows that the non-executives, certainly a majority of them, must be independently appointed – see above.

**Q7 What role should policyholders play in the running of life mutuals?**

Individual policyholders are so numerous – each a very tiny part of the whole - that they cannot play a meaningful role in running the Life Mutuals. Further, they lack the necessary incentive to spend time when any gains to themselves are uncertain and small. Finally, they lack the necessary knowledge. Competent and independent third parties must assume the role on their behalf, acting as trustees.

**Q13 What forces drive demutualisation, and how might they be addressed?**

Present policyholders can make significant and sometimes substantial gains from demutualisation. In effect they are cashing in the legacy inherited from past policyholders, and passing on no legacy to future policyholders. But in today's world, where the prevailing mood is for all financial and management players to take all they can as soon as they can, altruism is unlikely to prevail.

There is, however, one substantial further gain from demutualisation. The life company will gain substantial shareholders who will have much more influence with corporate managements than hundreds of thousands of small policyholders. If the quoted corporate sector is reformed then life companies will also become more accountable, including former Life Mutuals.

## **CONCLUSIONS**

The life mutuals are presently poorly placed to have fully accountable managements. They also lack any present mechanism for appointing sufficiently independent boards. And the risks to non-executive directors in all forms of life insurance companies is increasing to the point of unattractiveness. Life mutuals are presently equivalent to quoted companies with no institutional shareholders, only a huge number of very small individual shareholders. In such circumstances managements cannot be held sufficiently accountable. The need is therefore for imaginative new solutions. I do not claim my tentatively suggested solutions are the right ones – I lack sufficient knowledge of the industry. But the difficulties I have commented on are the key ones to address – and if not addressed then the consulting exercise will fail.