

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

17 September 2004
Direct Line: 01892 707226

Dear Sir

Myners Review of the Governance of Life Mutuals

I have pleasure in enclosing The Children's Mutual's response to the consultative document on the governance of life mutuals. The Children's Mutual is the trading name of the Tunbridge Wells Equitable marketing group, which includes as its core business Tunbridge Wells Equitable Friendly Society, a long established friendly society.

We are firmly of the view that consumers must have confidence in financial services organisations and that it is therefore crucial that mutuals can demonstrate high standards of governance. However, it is important that the Review does not confuse the debacle of the problems of the mutual Equitable Life with the wider corporate governance needs of the financial mutual sector.

Equitable Life's problems were not caused by just corporate governance failings; they were primarily caused by a suspect business plan that was almost certain, in the view of competitors, to fail once markets took a downturn.

Equitable Life trumpeted in advertisements, and in their selling that the company paid no commission to middle men, had the lowest overheads in the market, and as a result could operate on a very low capital base. At the same time, their investment performance was poor as evidenced by independently produced league tables. This strategy overlaid with guarantees was bound to fail if markets ever really turned against them, as they did.

We believe that we, in line with many other mutuals, do achieve and maintain high standards of governance, even though - as the consultative document notes - we are not subject to an oversight function carried out by informed institutional shareholders. We see informed participation of members as a crucial issue in this debate and in practice, we believe that a key function of our Board (both executive and non-executive members) is to protect the members' interests.

As a mutual organisation that has for many years provided our members with value for money and at the same time, endeavoured to operate in line with best practice in relation to

corporate governance, we are particularly interested in the consultation and the Review. As such, we would be pleased to meet with members of the Review team to elaborate on our response if this would be helpful.

The key points we would like to make in our response are:

- No corporate governance regime can eliminate corporate failure without eliminating business itself. The key has to lie in defining a regime that ensures key risks are mitigated appropriately.
- An adapted version of the Combined Code could provide such a regime for life (and non-life) mutuals.
- The fact that life mutuals are complex businesses is relevant but does not fundamentally alter the roles of the Board as a whole or individual directors (executive or non-executive).
- Active policyholder participation would be a positive step but there are real practical challenges to this not least the degree to which policyholders can commit time. There may be scope for a policyholder advisory board to represent policyholder views, although there are significant issues associated with such an arrangement, not least of which would be ensuring that the Board's responsibility for running the company was not undermined.
- We believe that much of the FSA's work in the area of approach to supervision, governance and indeed reporting has addressed many of the concerns raised in Lord Penrose's report on the Equitable Life. Any significant change in direction now would, we feel, be unhelpful to the industry and ultimately to consumers.

The Review does raise certain legitimate questions on corporate governance for financial mutuals. A review is timely and will be successful so long as those responsible recognise that just like other financial institutions, e.g. Investment Trusts, there are features unique to mutual life insurers which will not be found elsewhere and must be accommodated.

As noted above we would be happy to meet to discuss these issues or indeed any other aspect of the response or the Review's work.

Yours faithfully,

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Myners Review of the Governance of Life Mutuals – Summary of Questions

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 believe that the Combined Code does provide an appropriate framework for mutuals when applied in a constructive fashion. Our view is that most aspects of the code could be extended to mutuals, with appropriate amendment of the section on shareholder communications. In addition the code could be made compulsory and the extension of the principle of “comply or explain” to mutuals would be a positive development.

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

This is an interesting question as it could infer both that mutual life offices are currently exempt from any need to operate in accordance with corporate governance best practice, and that organisations which are neither mutual nor a life office always operate in a compliant way. Clearly this is not always the case. However, we believe a number of steps could be taken to make the position clearer for mutuals. We believe the Combined Code should be adapted to be relevant to mutual life offices by, where appropriate, substituting the term “members” for shareholders. Annual reports would then be presented in essentially the same way as those for quoted companies, although taking into account the different nature of such companies.

Obviously the key issue here would be trying in some way to replicate the oversight element of governance that institutional shareholders bring to quoted companies. One suggestion is that some form of members’ representative oversight committee could perform such a function, although this sort of solution would present some challenges (see Q7). Our main concern would be to ensure that a proper balance could be struck (and maintained) between such a committee and the Board, which would still have to carry legal responsibility for running the business.

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?

No. In our view the key has to be to identify an appropriate mix and balance of non-executive directors to ensure effective oversight of the Executive and development of strategy.

We see no reason why the principles of the Combined Code if applied should not lead to a position where the Board of a mutual had an adequate, balanced and appropriate make up of Executive and Non-Executive directors.

In our business we have sought to recruit non-executive directors from a wide range of backgrounds, so as to ensure a breadth of skills, knowledge, experience and outside interests at Board level that matches the issues facing the business. Through this approach we believe that we can achieve the necessary oversight requirements and also ensure that the Board plays an active role in the development of, and challenge to, any proposed strategy.

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?

In our experience, based on knowledge of mutual life offices, non-mutual life offices and other businesses, there is nothing inherently different in terms of information and advice received by the non-executives of a life mutual from that received by non-executive directors of a comparable shareholder company. Their ability to exercise effective oversight of the executive should also, therefore, be no different. We believe that the fundamental issue – irrespective of the corporate structure – is to have a suitably balanced group of non-executive directors. Ideally these will have been chosen for specific skills or experience, and necessarily they must be prepared to challenge the executive in a robust fashion whilst providing the required input to the business strategy.

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?

We would contend that to some degree the role is the same in a non-technical and non-complex business as it is in a technical or complex business. Essentially the non-executive director needs to be in a position to understand:

- The nature of the commercial area or market sector in which the business competes.
- The business strategy and its costs and benefits.
- The key drivers behind the success or otherwise of that strategy.
- The key risks to the strategy and the business.
- The key measures used to determine whether the strategy is being achieved.
- Possible alternative courses of action open to the business (together with potential costs and benefits) should the chosen strategy not be achieved.

The non-executive directors need to be in regular receipt of appropriate reports to allow them to make an ongoing assessment of how the business is performing. Just because the business is complex does not mean that measures and reporting cannot be provided that allows such an assessment to be made in an informed fashion.

In any event the non-executive directors must have the right to seek external professional advice – either as a group or as individuals - where they feel it is necessary. This right relates back to the previous question as it does require that the non-executives have the strength of character to pursue this line should it be necessary. It should be noted however, that this issue is no different in non-mutual and non-life businesses.

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?

See answer to Q5.

In our view non-executives should:

- Take an active interest in the business and regularly attend board meetings.
- Ensure executive management are competent through robust challenge and oversight.
- Where they do not understand a particular issue ask appropriate questions and if they do not receive a satisfactory response seek external professional advice.

Trying to codify this would not seem to us to be particularly helpful.

We believe that Executives and Non-Executives should 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?

Policyholders, or more precisely members, do have a role to play in the running of a life mutual in the same way as they do in any other mutuals. However, there are very real practical difficulties in generating member interest. The vast majority of members of mutual organisations have many more important (to them) things to do. Consequently, they will not be prepared to devote time to participate fully, particularly where this could involve the need to take part in a heavy initial and ongoing educational process. We have heard suggestions about the concept of a policyholders' advisory board or Consultative Committee. While we can see the intuitive attraction of such a body we believe the suggestion raises some fundamental issues, such as:

- can enough sufficiently committed policyholders be encouraged to participate?
- they would truly representative (or would they represent a particular group with a particular agenda)?
- how does their role fit with the role and responsibilities of the Board – e.g. if the advisory board wanted something to happen that the Board did not agree with what happens next?

None of these problems are insurmountable but they are also non-trivial. The point concerning the possibility of conflict between such a committee and the Board, in particular, potentially runs to the core of good governance and could undermine the role of the Board. As a result any such proposal would require careful consideration of how for example the relative responsibilities were reflected in FSA rules.

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?

In relation to this point we accord fully with the views set out by Drake and Llewellyn in paragraphs 3.19 and 3.20 of the consultation document.

In practice we believe that there is a greater affinity between the business and its customers than in a non-mutual with the opportunity for those who are prepared to commit the time to get involved through attendance at AGMs for example. In our business we do have some members who are actively involved, who communicate with us at the most senior level and who attend the AGM and ask whatever questions they are concerned about. Also at the AGM we have a range of speakers external and internal to present on issues facing the business. At this year's AGM we had the Chairman, Chief Executive and Finance Director speaking together with a representative from UBS, our main fund managers, and the Managing Director of

a consultancy firm specialising in outsourcing, which was directly relevant to our business. A policyholder with a quoted company would have difficulty in obtaining similar information, and certainly not delivered in this way.

- 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?**

We believe that the general thrust of the FSA's work has been correct in increasing the focus on senior management responsibility for how the business is run. However, we do not subscribe to the view that it would stop another Equitable Life, nor do we subscribe to the view that the Equitable Life's problems were inherently related to it being a mutual.

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

We do not believe there is given the other changes to regulation currently being driven by the FSA.

- 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?**

There are at least two presumptions in this question. Firstly it assumes that shareholders would have been able to identify the issues facing Equitable Life, and secondly that market forces act in a way that promotes good performance. This may be true for the shareholder but not necessarily for the customer or indeed for the future success of the business.

In terms of commentary on mutual life offices there are a number of independent commentators (e.g. Cazalet Consulting, AKG) who regularly review performance and financial status and whose views are published in the press (both consumer and financial).

The IFA market also refers to such analysis and the major IFAs have their own research functions which make assessments based on published information on different life firms (both mutual and non-mutual). It is perhaps interesting to note that Equitable Life were not operating in the IFA market and for many years comments from analysts had not been particularly positive about their financial position.

Mutuals, like all financial service companies are also subject to the scrutiny of the FSA. In particular the rules on both conduct of business and prudential supervision

have set out market boundaries that control what all market participants, including mutuals are allowed to do. Of course, the FSA's ongoing supervision process and enforcement powers support this.

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

The main barrier is access to capital. Finding mechanisms that would allow mutuals more easily to access capital would firstly increase the scrutiny from markets and secondly increase the flexibility that mutuals had to run their business.

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

Lack of access to capital has been a key driver in driving de-mutualisation and this has been compounded by for example price capping of products.

The implications for members and customers has we believe been mixed. It is clear that policies from de-mutualised mutuals have performed less well than their mutual counterparts. Whether this is a fair comparison is a matter of contention but the picture is clear.

Offsetting this, members will have in most cases benefited from a windfall at the time of demutualisation and this has to be considered when assessing the overall benefit.

Our view, based on IFA service awards is also that service from a reasonable number of demutualised companies has been less good than mutuals though this may well be to do with the necessary reorganisation as companies are consolidated.

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?

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

No.

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 have no detailed knowledge but recognise that Canada has a large mutual financial sector and may be worthy of consideration by the Review team.