ABI response to the Myners review of the governance of life mutuals

The Association of British Insurers (ABI) is the trade association for Britain's insurance industry. Its more than 400 member companies provide over 97% of the insurance business in the UK. It represents insurance companies to the Government, and to the regulatory and other agencies, and is an influential voice on public policy and financial services issues. ABI member companies hold more than a fifth of all investments traded on the London Stock Exchange, on behalf of millions of pensioners and savers.

The ABI response covers questions 1-11 of the consultation document.

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?

And

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

The Combined Code has become recognised as providing appropriate guidance on best practice for organisations that range well beyond the listed company sector. Mutual life offices, by the nature of their business activities, are much closer to plcs than many of these other entities. We therefore agree that the Combined Code presents a good starting point for Mutual life offices. There are however a small number of provisions in the current Combined Code which don't make sense or apply to mutuals (e.g. provisions B.1.2 and B.1.3 which relate to remuneration policy) and as a result we suggest that it is amended for mutual life offices.

In light of this, the ABI believes an obligation to report against the amended Code under a "comply or explain" framework is the most appropriate means of encouraging compliance with best practice. This will make visible the degree to which people and structures are appropriate, and require, where there is divergence from best practice, a public explanation for why this is considered appropriate.

An overarching theme as regards the effectiveness of accountability of companies to their owners is in the quality and extent of financial reporting. One important aspect of the reporting framework, the Operating and Financial Review, which at present is produced on a voluntary basis, is currently being taken further forward and put on a statutory footing.

We had already made clear in our response to the DTI consultation that the requirement to provide an OFR should extend beyond listed companies to non-listed companies of significant size. We would suggest that mutual life companies represent an obvious group of companies that would benefit from such an extension of the obligation to produce an OFR. In addition, as a

discursive rather than a numerical element of reporting as are the financial accounts, the OFR is likely to be a relatively ‘accessible’ document to the informed or educated layman i.e. the type of individuals who are likely to be comprise a significant portion of the ownership base of mutual life companies.

Although mutual life companies do not have a concentrated group of major shareholders with appropriate skills in assessing corporate governance compliance, the reality is that they, in common with most financial sector companies with a predominantly retail customer base are subject to considerable scrutiny by the media. Combined with high disclosure standards, this will help hold companies to account where necessary.

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?

We strongly believe that all directors should represent the members of the company and we would expect that a unitary board structure, embodying this principle is recognised as equally appropriate for mutuals as it is for listed companies.

There is no obvious reason why the mutual status of a company need influence the composition or balance of its board and committees. It would be, moreover, reasonable to expect the board composition of a mutual to be broadly similar to those of a proprietary company of equivalent size and scope of its business activities.

There is nothing fundamentally different about a life company (whether proprietary or mutual) that should affect the composition or structure of the board. Relevant knowledge and experience of candidates for the board will be just as significant for life mutuals as for listed proprietary life companies or, indeed, any listed company in other sectors of the market.

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?

The Combined Code states ‘the Board should ensure that directors, especially non-executive directors, have access to independent professional advice at the company’s expense where they judge it necessary to discharge their responsibilities as directors’. This should be an established matter of principle in all companies.

In addition to calling on independent advice, non-executive directors should be expected to seek information from management as necessary and ensure that they obtain full and satisfactory answers to any questions they may have. The resource implications of getting independent advice need not, and indeed should not be, onerous if a company is well run and the board well-informed anyway. The issues relating to the provision of independent advice for non-executives can arise in any company, not just complex, financial ones.

In the particular case of life offices, (including mutuals) the FSA has imposed a number of new regulatory requirements, including realistic reporting and the publication of Principles and Practices of Financial Management (PPFMs) which will improve and increase the amount of information available on their with-profits business. While these changes have been introduced primarily for the benefit of consumers and the regulator, they should also prove useful resources for non-executives in providing comprehensive information about the running of these complex funds.

Where non-executive directors are not satisfied that they have been provided with information of the quality and relevance required either for the Board to reach fully informed decisions or for them to exercise effective oversight of the executive management, they must be prepared to ask for, and insist that they receive such information.

Finally, the new Combined Code places a greater emphasis on the Board evaluation process and the important role it should play in monitoring the effectiveness of individual board members as well as the Board as whole. As there are no shareholders to scrutinise Board performance in a mutual life office, the robustness of this evaluation process is perhaps even more important. In his report on role and effectiveness of non-executive directors Higgs suggested that the 'conduct of the evaluation by an external third party can bring objectivity to the process and its value should be recognised'. The specific circumstances of mutuals may make the value of external input in the Board evaluation process even greater and should be considered by the Chairman.

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 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?

There is no fundamental difference between the role of a non-executive director in a complex or technical business or a non-executive director in any other business.

We believe that it is unrealistic to expect each non-executive director in a complex financial company to be fully versed in every technical detail about their firms business. What they do need to be, however, is sufficiently knowledgeable and on top of the detail to be able to identify when it is necessary for them to seek independent advice or to demand greater clarity from the executive management.

What is particularly important is that they have the capacity to know when questions should be asked and have the strength of character to make sure that they receive a satisfactory answer. We believe that these characteristics are vital in any non-executive director if they are to fulfil their roles effectively, not simply ones in a complex or technical business. Certainly Higgs recognised the general importance of these traits in his report stating 'all non-executive directors must be able and willing to inquire and probe. They should have sufficient strength of character to seek and obtain full and satisfactory answers within the collegiate environment of the Board'.

It is, however, clearly desirable that the non-executive directors collectively have knowledge and expertise and it is important that an appropriate balance be maintained amongst the independent members of the board. The Combined Code has introduced a specific requirement for one independent board member sitting on the audit committee to have particular expertise of a financial nature and it is possible that this concept could be further developed in future to identify particular skills which need to be present in at least one of the independent members of the board. Again, this is a not a mutual or sector-specific matter. In the case of a life company one might be looking for a balance of experience in financial matters, regulatory matters, even though the individuals themselves may not have been actively involved in life company business activities.

The role of the nomination committee is of key importance at the recruitment stage. On an on-going basis the adoption of a process of board evaluation in line with the Higgs recommendations as annexed to the Combined Code will be of particular relevance.

We strongly believe that non-executives in any unitary board are full participants in the decision making process. They cannot have lesser legal duties than executive directors as that would undermine the whole concept of the unitary board and removes discipline from the decision making process.

However in the ABI's response to the Government's consultation on directors' liability we made it clear that we do not think directors should be sued for something for which the company rather than individual directors is actually responsible. In the present context this might mean wilful breach by an executive of clearly established board guidelines of behaviour and transparency.

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?

And

Q8. Lord Penrose says that in a life mutual "it is the policyholders who are the source of risk capital for the enterprise." (chapter 20, paragraph 51). What does this mean for the relationship between a mutual life office and its policyholders?

Participation by member policyholders in mutual companies should be, in principle, no more and no less than that of shareholders in their listed plc counterparts. Shareholders do not 'run' plcs. Neither should member policyholders 'run' mutual companies.

The practical reality is that plcs are responsive to the concerns and interests of their major shareholders who will generally be professional institutional investors. Responsible companies engage in dialogue with their shareholders recognising the role that responsible owners should play. As we say in our response to questions 1 & 2, the different ownership base of life mutuals does not necessarily represent a block on the substance of accountability. Indeed there are a number of diverse models of policyholder engagement used by mutual life companies including delegate systems and members groups.

In relation to risk capital, it is the retained earnings of all generations of policyholders that represents this for a mutual enterprise. There is not, therefore, any necessary tension in the relationship between mutual life office and those who happen to be its present generation of policyholders. There is a reasonable case for suggesting that mutual companies should have a tendency to be more risk averse than proprietary ones, in so far as options for corporate growth requiring the injection of new equity capital will be unlikely to be viable and they must instead rely more on retained profits.

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?

And

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

The FSA already has a number of effective instruments at its disposal with which they can routinely check the corporate governance standards of both mutuals and proprietary companies.

As we have identified in our earlier answers, non-executive directors have a crucial role to play in acting as a check on the executive management. The FSA also play an important role in this area and have significant powers to oversee the performance of the executive members of the Board, particularly through the Approved Persons regime.

The Approved Persons Regime prohibits anyone other than an approved person from undertaking a 'controlled function' – this includes exercising a significant influence on the conduct of a firm's affairs. Individuals have to pass 'the fit and proper test' in order to become approved persons and are obliged to act in accordance with the FSA's seven statements of principles at all times. The FSA also has the power to remove approval of individuals that it considers are not fit and proper.

Overseeing and policing the Approved Persons regime gives the FSA considerable power when it comes to assessing the standard of a company's corporate governance and the performance of their executive team which compliments the strengthened role of the non-executive as outlined in the Combined Code.

In addition to these more formal powers, it is well within the remit of FSA supervisors to ask any questions they wish to firms about their corporate governance arrangements if they have any specific concerns.

We therefore believe that the FSA already has ample powers at its disposal. As well as the Approved Persons Regime, the FSA can also use ARROW visits to investigate the standard of a firm's corporate governance for instance. On top of these more general tools, the regulator has made a number of significant changes to the governance of with-profits funds in particular to make them more transparent e.g. the creation of with-profits committees, the publication of PPFMS.

As a result of the already extensive powers the FSA have in this area we do not favour increasing them further. Indeed it is difficult to see why or how the FSA's powers in relation to mutual companies should exceed those in respect of proprietary companies. We believe the focus should be on ensuring that the current tools available are used effectively. Recent evidence suggests that the FSA is indeed taking its role in this area more seriously.

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 effected?

Mutual companies will not be subject, as their listed counterparts are, to the full impact of the market in corporate control and the potential threat of the hostile takeover. Nevertheless, it is clear from the experience of recent years that mutual companies, in the life insurance sector and more widely, have been subject to a discipline that is analogous to that of takeover viz the existence of an alternative strategy de-mutualisation and the prospect that substantial value could crystallise for the present generation of members.

The boards of mutual companies need to demonstrate to the satisfaction of their members that the present arrangements are more beneficial just as boards of plcs need to demonstrate to the market and to their investors that a bidder would not create greater long-term shareholder value than the incumbent management would be expected to. In addition there are a number of strong external checks and balances on mutuals just as there are on proprietary companies – ratings agencies, distributors, independent analysts and the media for instance all perform the same scrutinising role on mutuals as they do on plcs and will raise questions about the effectiveness of Boards where necessary.