Myners review of the governance of life mutuals – Consultation response from Steve Dixon Associates

Consultation response contact details:
S. W. Dixon
Principal
Steve Dixon Associates
Global House
1, Ashley Avenue
Epsom
KT18 5AD
Tel: 020 8823 9163
Fax: 020 8823 9166
Email: steve@stevedixon.co.uk

1. Introduction and general comments.

I would like to thank the review for this opportunity to respond to the initial consultation.

We are a small actuarial consultancy currently acting as appointed actuary and appropriate actuary to a number of small mutual life offices (all currently friendly societies although we have advised a mutual insurer). We believe that small mutuals are essential in bringing diversity to the financial services market. We are currently tendering to provide actuarial services to a friendly society that still maintains home collection and, therefore, deals with people that would otherwise be financially excluded. We have clients who provide sickness benefits to people of modest income at low premium levels.

Originally, mutuals were a response to a particular financial problem. No-one could identify with any certainty the cost of a particular insurance coverage (the cost of life cover). The choice was between insuring with a commercial organisation that would either not take the long term risk or charge too much for the risk. Into this vacuum came mutual insurers who charged a larger premium than required and then split the profits made between the members. The 19th and 20th centuries saw the replacement of the death risk with the investment risk.

Mutuals still succeed where there is fundamental uncertainty. An example might be trade organisations starting mutual general insurance operations. Capital, premiums and profit are shared between members of the trade with "top-end" reinsurance coverage being sought in the commercial markets.

To some extent, life products exist today where there is fundamental uncertainty on the cost of cover. This would include long term private medical insurance, long term care insurance and (increasingly) annuities.

Smaller friendly societies tend to have committees of management (or boards) that are nearly exclusively all non-executive. Often, the only executive director is the Secretary or Chief Executive. I have attended a number of board meetings for these societies and I have been pleasantly surprised by the extent to which the board members have the interests of the members of the society in their mind at all times. Quite a large amount of time may be spent in discussing whether a particular insurance should attract benefits beyond those stated in the tables due to some ownership rights in the society. Discussions of the finances are always met attentively and some very pertinent questions are asked.

There could be a tendency for the board to rely too heavily on the actuarial advice given. To some extent, this depends on the nature of the actuary providing the advice. We have taken over from some actuaries who had obviously spent considerable time explaining their financial models and consequences of their advice with the board. We had also followed on from some actuaries who have spent considerably less time and operated on a "need to know" basis. We have found that the first group generally outnumbers the latter group.

We have found that the FSA have, increasingly, had a considerable influence over the make up of the board especially the non-executives. Societies now tend to have lists of expertise that they need and use this as a shopping list for non-executive directors. Many societies still require all non-executive directors to be members of the society. To some extent, this restricts the pool of talent from which the board can call. However, it can also act positively in making the identification with members very strong.

I have found that the best type of non-executive director frequently has no experience in the financial services industry but has some business experience. They are able to draw parallels between the finances of the society and the finances of their own businesses and are able to ask questions like "why are you saying this...", "what happens if". Public sector officials often provide a vital role as non executive directors. They frequently have very well developed instincts on governance and who should be making what decision when and how the decision process should be documented. In many cases, the public sector is miles ahead of the private sector in corporate governance. The best boards seek a mixture of non executive directors with the best chairmen encouraging members to ask questions that no-one else has thought to ask.

Boards are taking very seriously the new clarity of what their responsibilities are. The times when you hear "oh, we'll leave that to you.." are fast dying (thank goodness).

There is a real restriction in founding new mutual insurers. The amount of capital required to establish a mutual insurer is considerable. Not many groups of individuals exist that can provide this level of capital to self insure. We believe that this is not desirable for the financial services market. New needs are arising with the ageing of the population which will not, naturally, be met by commercial insurers. New life mutuals targeting a particular affinity group could provide these products by pooling or sharing the risks.

We also believe that the current trend on "fairness" will also militate against mutuals continuing to succeed in the future. With the end of pooling and the move to paying out to the member his individual "share" of the fund, it is less likely that new risk sharing mutuals can succeed. The new World will always require shareholders to cover the capital cost of the risk or provide capital to establish an entity.

Therefore, a rather gloomy prognosis might be that, irrespective of any new corporate governance, mutuals are doomed. They are written off by financial journalists and the FSA in their demands that the provider of risk capital must be someone outside the policyholders.

To some extent, building societies have demutualised as their boards have lost the risk sharing attitude to members. No longer are they groups of individuals sharing capital to be able to buy properties. They became banks and a bank is better run on shareholders capital.

We believe that this prognosis is too pessimistic. The pendulum has swung too far to individual rights, it must swing back to cooperative risk bearing. I would urge the members of the review to keep in mind the co-operative risk sharing and pooling nature of mutual life insurers above all else in their considerations. There is a finite supply of mutuals, due to the difficulty of establishing new ones, and we wish them to have some chance of success into the future.

2. Answers to the specific 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 would suggest that a new code should be considered appropriate for mutual life offices. The code should be simple to understand, should take account of the scale and size of the mutual and should include (replicate to the letter) the requirements of the FSA on corporate governance. The mutuals need a code that will not conflict with the requirements as laid down by the FSA. The code should emphasise the need to make

decisions for the benefit of the whole membership; to have the required skills; to hold the executive to account and to gain the right professional support.

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

To tie in with the FSA and ensure that the FSA ARROW and monitoring teams use the corporate best practice in both their risk assessments of the mutuals and in likely follow on enforcement action. The FSA have people on the ground already carrying out some of this work. Building in a sensible framework to their monitoring seems a sensible way to ensure compliance.

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?

Yes is the short answer.

The longer answer is:

1. Nature of the business. The nature of the business affects the skill set required by the office in its board. Being a financial mutual requires some business acumen, some financial skills, some understanding of compliance and corporate governance and some marketing skills on the board.
2. Ownership structure. It must be desirable that most of the directors should be members of the Society if not all the directors to enable the board to act as representatives of the membership.

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 may 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?

For actuarial advice, I would suggest that professional guidance does require the right amount of information. I would suggest that more emphasis needs to be placed on the actuary communicating his advice and ensuring all of its implications are understood. The standard valuation pack provided by most actuarial practices to medium and smaller mutuals would include:

1. statutory valuation results and analysis of movements;
2. sustainable bonus rate valuation showing what bonus rates can be sustainable going forward (normally referred to as a realistic bonus reserve method valuation) and analysis of surplus;
3. some approximate asset share calculations;
4. what your competitors are doing;
5. results of experience analyses in the year.

All of this is normally backed with reasons why and the actuary tries to communicate the result in a short 20 – 30 page report.

Appointed actuaries are also required to provide a Financial Condition Report which is basically a report on the business plan of the company with lots of what ifs.

Communication is, obviously, vital on the complex issues provided.

Training in the non-executive's role would be useful. Most of the time, this should build confidence in the NED to be able to ask questions and not be satisfied with easy or pat answers. I would suggest that a course run jointly with the FSA and the IoD would meet this requirement. The courses should be free to the mutusal

and to the NED with the mutual expected to pay the individual's travelling costs. Courses may need to be run at the weekend as most NEDs in smaller mutuals tend to have full time jobs. Board meetings of some organisations are frequently on Saturday morning. The cost to the FSA would be minimal but would provide considerable benefits in terms of trained NED's.

Support from a body such as the IoD combined with the FSA would also be useful. Web based discussion groups with privacy could be useful.

NED's should, probably, have whistle blowing responsibilities similar to actuaries and auditors.

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 matters?

The role is to:

- be responsible with the executive members (normally just one person) for the running of the business in all key decisions;
- to hold the executive to account on their day to day decisions;
- to set discretionary benefits (bonus rates)
- to decide marketing and sales strategy
- to accept the financial reports.

It could be hard for a non-executive to hold an executive to account if the executive is very forceful and the NED chairman is not supportive. I am assuming the chair should be non-executive. However, training and support can overcome this.

Q6: What can the owners of a complex and 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?

I will only answer the latter question. The answer is yes. If they did not, then a division would open in the board and some members might not exercise their duty of oversight because they felt they were no longer liable.

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 should be able to vote in directors and vote them off the board. They should be able to ask for their propositions to be included in any mailing to all members before an AGM and that they could include a proxy form on the issue. They should have presentations on the financial health of the society from the actuary and auditor. They should have presentations on the likely business plans (in outline) from the executive and how the business plan has performed over the last year.

One of the practical constraints is the lack of a standard AGM structure. This could be addressed in any code of corporate governance. Another practical constraint is the lack of time normal people have now to understand complex issues and read complex documents. Simpler forms should be used.

PPFM's should be extended to smaller mutuals but in much reduced and simplified form dealing with only the top 5 points.

Q8: Lord Penrose said that in a life mutual ".. it is the policyholders who are the source of the risk capital for the enterprise." What does this mean for the relationship between a mutual life office and its policyholders?

The policyholders are also owners of the business and should be treated accordingly. Most boards take this point very seriously. It also means that a large part of the expected benefits for the member are at risk from the business activities of the society.

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

The actuary's role has been split but has largely been reinstated and it is very likely that most appointed actuaries will hold jointly the role of actuarial function and of with profits actuary. The auditors responsibility will provide an extra pair of eyes although this could have been achieved by published peer review possibly more cheaply. The board is now more keenly aware of its responsibilities although these have not changed in theory. The FSA have no extra powers now than their predecessors had. Most small mutuals will not provide any further reporting data to the FSA.

The FSA is now more keenly aware of the issues and this is to be welcomed. They have also insisted on more professional boards. This has had a positive impact.

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

Yes. See the answers above. I think the FSA could and should take a central role in this. They are the prime regulator and it is best if ALL rules and codes emanate from them to ensure that their authority (and their responsibility) is not split.

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 producing good performance and how might they be enhanced?

The vote is the most effective form of control. The voting mechanisms probably need strengthening.

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

There is a barrier to forming a new mutual in the ability to raise the capital required to meet the solvency requirements, the ability to spend the time negotiating with the FSA on gaining a licence (this can take 3 years at the extreme, one year at the shortest) and on accessing the technical skills to make a success. The new requirements that all payouts reflect all of the contribution that an individual has made to a fund also undermines the principle of risk sharing and pooling and would make a mutual difficult to run without a large unattributed value (estate) to use as backing capital.

The latter can be addressed simply by bringing back these concepts. The former is difficult to handle as the FSA are right to require good business plans and sufficient capital. They may be able to react more positively to approaches from people wishing to start mutuals and provide assistance (especially on helping source

technical skills) when required. They are frequently seen as an insurmountable barrier to establishment in the UK. It is far easier starting up in Dublin or in the Channel Islands.

The eventual death of the with profits plan also removes the provider of risk capital from most mutuals.

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

The forces are:

1. need for new capital for management;
2. management status and (possibly) pay rates;
3. carpet bagging and the potential quick payment to members;
4. the lack of identity with the mutual by the members.

The implications are that they have possibly lost an institution that should have looked on them as "members" rather than "customers". This may not bother many people.

Q14.

No comment.

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

Yes. The smaller firms tend to have a stronger sense of membership and club atmosphere. They also tend to have problems of a smaller pool of talent and a small amount of resources. Most small mutuals tend to pay only small amounts to their board members.

Q16:

No comment.

S. Dixon
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