

CORPORATE GOVERNANCE FOR MUTUAL LIFE OFFICES

From R.W.B.Judson, 15th September 2004

Dear Mr Myners,

I write in response to your invitation to comment on the role of non-executive directors in a mutual life assurance office.

INTRODUCTION

During my career I spent 27 years working for two mutual life offices in the actuarial and investment departments but never in the Boardroom.

I have been interested in management techniques for many years. I have read reviews of the various Reports on Corporate Governance and concluded that they did not pay sufficient attention to the role of the non-executive director, hence my interest in giving you my views.

My comments apply to the non-exec role in all large or complex companies and I have added a specific section for life assurance companies, mutual or otherwise.

1. THE FIRST STEP

I believe all non-execs should, on appointment, receive the following documents

a) a leaflet, ideally from the IoD, stating in general terms the role of a non-exec, his responsibilities and the liabilities he accepts. It should suggest a minimum amount of time that should be spent on a company's business and the maximum number of directorships anyone should accept.

b) a leaflet from the company explaining the company's business, outlining the functions of the principal divisions together with a management chart showing names and job titles of the executives.

c) another leaflet from the company setting out the objectives for the year. This might be simply a copy of the executive summary of the latest update of the company's business plan, a copy of which should be available in the Boardroom at all times.

d) perhaps separately, or incorporated in a), there should be comment on the meaning, objective and need for Corporate Governance. Also details of courses the IoD runs for new directors. I believe attendance should be compulsory for everyone new to the non-exec role.

I believe the Chairman should make regular checks to ensure that all non-execs really do understand the contents of these documents, with particular emphasis on c), thereby endeavoring to ensure that the directors are working as a team towards the named objectives.

2. SELECTION OF NON-EXECUTIVE DIRECTORS

I worked in a Mutual whose Board contained four or five merchant bankers, a Unit Trust manager and an investment company manager. All were chairmen or managing directors and eminent names in the City.

I believe such a concentration of similar business backgrounds should be avoided.

I believe a non-executive should be chosen because of his specialist skills which coincide with one of the company's principal divisions but so that between them these non-execs skills will cover all aspects of the company's business. Between them they will thus form a team to provide an independent and continuous review of the main activities.

3. THE ROLE OF NON-EXECUTIVE DIRECTORS

I believe a non-exec should be required to spend at least one day per week working on the company's premises. This should not include the time spent preparing Reports for the Board or time spent reading, analysing and preparing debate on other member's Reports to the Board. Nor should it include time spent in Board meetings.

Incidentally, if not already done, I would expect the Chairman (if himself a non-exec) to organise two Board meetings, the first solely for non-execs and discussion of their Reports, the second being the normal full Board meeting.

Each non-exec should work in the departments where he will be able to apply his special skills to ensure he is satisfied with what is going on, to offer suggestions for improvements and particularly to ensure appropriate controls exist and are being observed. He should, of course, be free 'to roam'.

An overall remit to examine financial aspects should help curb any excessive expenditure.

The regular presence of a non-exec director would, I believe, increase staff morale and efficiency, particularly if the director was prepared to talk, both formally and informally, to middle management and the rank-and-file. It is these people who represent 'the power house' and often have good ideas about what is wrong and how to put it right.

4. STAFFING THE MUTUAL LIFE OFFICE BOARD

A life assurance operation is a complex one. However, some activities are common to many types of company. It should not be difficult to find people for non-exec roles with skills in Sales and Marketing, Branch management, Training, Accounts, Personnel (and possibly Admin?).

There are plenty of people with expertise in Investment management but for Life Office work they need to appreciate the requirements of a Life Office fund. Anyone taking on a non-exec responsibility in this department should be required to read a selection of investment books selected by the Institute of Actuaries.

Investment (and Accounts) departments should be subject to quite extensive controls. These must be strictly adhered to and kept under constant review. The non-exec elected for his investment experience should examine these controls, ensure they are foolproof and are being observed. He needs to be able to comment on general investment strategy, asset distribution and risk management. These days he also needs to be an expert

in the use of all forms of derivatives and to understand the operations of hedge funds because these are areas where many ‘accidents’ can happen. e.g. Barings

The most complicated function in a Life Office is the actuarial one. This includes, inter alia, the design of new products and the calculation of premium rates, the valuation of liabilities and possibly some input in the valuation of the assets, the calculation of the surplus and the amount which can be distributed as bonus. Also there should be some input to ensure the accuracy of marketing literature (This may be an area contributing to Equitable Life’s downfall). I believe these aspects of a Life Office can be fully understood only by an actuary and therefore the non-exec panel must include one such professional and he must never have worked for the company. Included in his brief should be a requirement to provide basic actuarial education to the other non-execs.

A major aspect of Life Office work is administration. Much of this is common to all sorts of companies but the special feature is the need for massive data processing to keep policy records up-to-date to facilitate the annual valuation and the answering of daily queries from policy holders. This work is handled by computers so it needs to be overseen by a non-exec with in-depth IT knowledge covering hardware, software and ideally some knowledge of the industry. This is another area where much can go wrong by accident or on purpose and much effort needs to go into testing and conforming to controls.

This IT non-exec should also bear in mind the possibilities for increasing productivity as he ‘roams’.

5. PROBLEMS PAST AND PRESENT

Over the last few years we have witnessed several major corporate scandals. Some were deliberate, some were covering up mistakes and others were just due to bad management.

In many of these the non-execs have tried to absolve themselves from any liability on the grounds that their job is to help in the Board’s decision-making and to do this they are entitled to rely on the information given to them by the senior executives (ref Equitable Life and now Hollinger).

I believe this attitude of non-accountability by non-execs is a fundamental flaw in Corporate Governance and it needs to be addressed. At present non-execs seem to think it is their right to expect flawless information without any need to query anything. This attitude gives freedom to any ‘crooked’ executive and must be challenged.

Hence my belief that non-execs must be made more accountable and should act as ‘independent watchdogs’ by actually working within the company. Yes, this will make it more of a job than a perk and Yes they will have to be paid more.

6. ON ANOTHER TACK

I believe there should be some formal investigative procedure whereby any director of a corporate disaster should be vetted before being eligible to take on, or continue with, a non-exec post in another company. This would address the problem of how this director sees his responsibilities and his own skills in respect of his directorship. I believe two of the non-execs of Equitable Life came from failed organisations and have tried to absolve themselves from any responsibility for E.L’s plight on the grounds that they should be entitled to engage in the decision-making processes on the assumption that

information from the executives was accurate and all-embracing. I believe they also expressed the view that the business was too complicated for them to be expected to understand it. In this case why did they accept the job, how thoroughly were they interviewed and why were they offered the job?. Perhaps the question of interviewing should be incorporated into my section 2.

My comments herein are designed to help ensure that in future the non-execs are far better informed than many are at present and that they have specific responsibilities commensurate with their skills. Surely they should be acting as watchdogs on behalf of policyholders or shareholders.

Yours sincerely,

R.W.B.Judson