

FAMILY ASSURANCE FRIENDLY SOCIETY LIMITED - RESPONSE TO THE MYNER'S REVIEW OF THE GOVERNANCE OF LIFE MUTUALS

Family Assurance is pleased to have the opportunity to respond to the Myner's Review of the Governance of Life Mutuals. In constructing this response we have taken into account the views of our Executive and non Executive Directors on the issues raised.

Family Assurance is a friendly society and was established in 1975. The Society manages around £1.5 billion on behalf of its 566,000 members who collectively hold 750,000 policies and plans comprising Friendly Society Tax Exempt Savings Plans, Peps, ISAs and Unit Trusts.

General Comments

Friendly Societies are not specifically mentioned in the paper, but we assume they are within the scope of this review. Where we believe there are differences between Friendly Society governance and other life mutuals, we have tried to identify this.

The paper is driven by and quotes much from the Penrose report. It indicates that Equitable was a failure of governance, but we wonder whether it was simply bad management that might have occurred under any form of governance. We understand also that regulatory failure might have contributed to Equitable's problems: perhaps indicating that the regulations were adequate but not properly enforced. As such there needs to be a co-ordinated and proportionate approach to the resolution of both issues.

By comparison to previous regulatory regimes we believe that governance is much tighter under FSA and we would therefore question whether any further significant change is required.

Responses to Specific Questions

CORPORATE GOVERNANCE GUIDANCE

Question 1

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?

In general, the Combined Code provides an appropriate framework for Life mutuals and in our particular case, as might be expected of a modern and relatively new mutual, the Table on the following page shows that the Society's

governance structure complies already with much of the Combined Code (including the Higgs & Smith recommendations) and we have not found it particularly difficult to do so.

<u>Combined Code (7/03)</u> <u>Key Principle</u>	<u>Compliant</u>	<u>Non Compliant</u>
• Independent Chairman (A2)	Yes	
• Role of Chairman and CEO separate (A2)	Yes	
• Board comprises majority non executives (A3)	Yes	
• Nominations Committee	No	Will be formalised prior to next appointment
• Timely provision of quality information to Board and professional development (A5)	Yes	
• Evaluation of Board performance, members and committees (A6)	No	Current approach might need to be made more formal.
• Re-election of Directors	Yes	
• Remuneration: adequate to attract, retain and motivate but not excessive. Remuneration Committee (B1 and B2)	Yes	
• Financial Reporting – balanced and understandable (C1)	Yes	
• Systems of Internal Control (C2)	Yes	
• Audit Committee (C3)	Yes	
• Dialogue with Institutional Shareholders (D1)	Yes (with members)	
• Constructive use of AGM (encourage participation) (D2)	Yes	
• Institutional Shareholders (E)	Not applicable	Not applicable

Question 2

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

As stated above, we have not found it difficult to comply with much of the combined code, which we adopted on a voluntary basis believing it is in the best interests of our members in terms of transparency and governance. We would therefore have no significant concern if the current code was made more binding on us. Whilst it would of course need to reflect the differences between plcs and mutuals (eg.shareholders/members) in principle the concept of a similar code for

mutuals would be acceptable to us.

BOARD EFFECTIVENESS

Question 3

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?

It is our belief that the composition, structure and skills of the board should reflect closely the nature of a firm's business. To this end, we have a Committee of Management comprising 9 members of which 4 are executive and 5 non-executive including a non-executive chairman.

The complexity of With Profits actuarial issues, together with the failure to manage adequately the conflicts of interest within Equitable, appear to have been the prime cause of Equitable's problems. FSA has done much to address these issues.

Our Society manages predominantly unit linked business – not With Profits. As such we believe actuarial issues, whilst still important, are less complex and therefore perhaps less important than sound financial and investment management processes and controls. The nature of our business is therefore reflected in the skills and composition of our Board.

The capacity of non executives to challenge the executive depends on the skills, knowledge and experience of the former. Our non executives, collectively, are competent in what we believe are the key areas for our Society: legal; accounting; actuarial; PR/marketing.

Life mutuals are FSA regulated and will therefore be subject to FSA's rules regarding Approved Persons, Systems and Controls, Training & Competency etc., which have helped to underpin governance (but see answer to Q. 10).

Question 4

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 Society's non-executives rely on high quality financial and actuarial information and advice supplied internally by the Society's Senior Management, Compliance and Internal Audit departments and Executives. This is further

supported by high quality information and advice provided by our external advisers: auditors, appointed actuary and legal. We believe these arrangements have served the Committee of Management and the Society's members well over many years and could not be significantly improved upon.

Question 5

***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,***

Question 6

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 the 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?

At high level the role of non-executives is to ensure that the executives are managing our Society in the best interests of its members by providing an independent perspective of the overall running of the business.

We believe the legal duties of Executives and Non Executives should be the same, but application of the law needs to take account of the fact that it is unrealistic to expect non-executive directors to have the same level of detailed knowledge of the Society as its executives. Non-executive directors should have a mix of broad generic knowledge and skills to be able, collectively or individually, to challenge the executives. Therefore recruitment of the right individuals to non-executive director positions is important and perhaps FSA's Approved Persons regime might better control the appointment of non-executive directors to ensure they have appropriate skills (see question 10).

It is our view that non-executive directors are able to exercise greater control when they have a detailed grasp of how the firm operates – such knowledge can take time to acquire and we therefore believe that suggestions to limit non-executive director service to say 7 years could be counter productive.

POLICYHOLDER VOICE

Question 7

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 not run Life mutuals: an important principle in the relationship between a Life mutual and its members is that members elect management but then allow management the freedom to manage. We would not wish this principle to be diluted nor constrained in any way beyond the adequate safeguards that exist already in existing legislation and regulation. The rules of our Society make it relatively easy for members to call a meeting of members, propose resolutions and nominate Board members if they so wish.

The Friendly Societies Act 1992 provides a framework to enable members to be informed of and be able to vote on key business decisions.

Our rules (which are framed around and are in compliance with the 1992 Act) allow, in theory, members to stand for election to the Committee of Management though in practice it is our experience that few have shown interest in doing so: it is possible that the increasing publicity around the liability of directors and the FSA Approved Persons regime increasingly acts as deterrents.

Our group comprises a mutual friendly society and a number of subsidiary companies through which business such as Unit Trusts, PEPs and ISAs are written. To ensure equity between these different groups of policyholders the Society elected in 1997 (at its AGM) to give membership rights to all customers including those of its subsidiary companies.

As a provider of low premium (and therefore low margin) savings plans there are greater pressures in terms of the cost considerations of engaging our members: openness and democracy comes at a price and is more easily accommodated by larger organisations who can achieve economies of scale.

Cost considerations are a key concern and we would hope that the Myners review gives due consideration to this particular issue and takes into account also that the financial services industry is being encouraged increasingly to move to lower margin Sandler type products. The effects of this will be: (a) to exert downward pressure on costs; (b) reduce investor risk through lower charges and easier exit without penalty; and (c) to introduce enhanced product regulation. The combined effect should lead to improved investor protection and arguably lessen the need for tighter governance – provided of course that the new cost pressures do not increase the risk of insolvency.

We have experimented with a variety of ways of, for example, notifying our members of our AGM: from a minimalist approach at one extreme to serving individual notice to all at the other. Either way it makes little difference to the number of AGM attendees. We were pleased that our 2004 AGM (notice of which was served to all members) attracted 30,000 proxy votes and we believe this compares favourably to Plc AGMs. Nonetheless this represented a response of less than 10% of our total membership and we continue to explore other ways of improving this, however it is possible that our low premium business means that our members are less interested or inclined to engage with the Society.

Question 8

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?

We believe that FSA's new regulatory regime generally reduces the scope of firms to take significant business risks.

As a mutual we do not feel under the same pressure as proprietary companies to create instant/short-term value for shareholders which might encourage high-risk strategies. The interest of our members is paramount and our focus is centred on providing them with a valuable service which results in a longer term return on capital employed.

If the industry moves increasingly towards Sandler- type charge capped products the result will be that new members of mutuals will provide reduced levels of risk capital than in the past, particularly in the early years of these new products.

The terms of some products offered by Life mutuals, which include eg. early surrender penalties, may not enable disaffected policyholders to make an easy / penalty free exit from a Life Mutual. We believe however that Sandler-type penalty free and easy access products will enable increasingly more policyholders to “vote with their feet”. In our case, for example, in entering the Child Trust Fund market we anticipate that by the end of next year the majority of our members (increasing each year thereafter) will be able to exit at any time without penalty and at little notice by virtue of the fact that they hold an ISA, Unit Trust, Child Trust Fund account or life policy that is no longer locked in to a fixed term. This provides a strong incentive to the Society's management to manage diligently our business in order to retain satisfied members.

REGULATION

Question 9

Lord Penrose acknowledges that the FSA's work since 1997 “... has sought to anticipate many of the lessons that might be drawn by this enquiry 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 agree in so far as the changes that have been made to With Profits mutuals and assume that further recommendations may arise from the Parliamentary Ombudsman review of the regulator's role in the Equitable problems. Outside of the With Profits sector it is our view that the changes made as a result of FSMA

2000 (i.e., Approved Persons and Systems and Controls regime) has tightened governance generally. Such change has of course taken place since the Equitable problems arose and so we believe there is little scope for improvement beyond that noted in our answer to Q.10.

Question 10

Is there a further role for the FSA to play in improving a firm's corporate governance?

Possibly:

- ❖ It is not clear to us whether the Approved Persons regime takes into consideration or explores in any detail the necessary skills required for say the appointment of a non-executive director: if it does not, perhaps it should.
- ❖ The role of FSA's Mutual Societies Registration department is not clear to us. Its prime role appears to be to provide a vehicle for public access to e.g., the rules of a Friendly Society and in that regard it handles changes to the rules of a society. In practice it is our experience that the department also sees itself as having a screening/vetting role as they have asked us to explain the intention behind certain rule changes. If so, this potentially acts as a brake on undemocratic management decisions.

Arguably FSA's "Treating Customers Fairly" initiative is already encroaching into corporate governance territory. We agree with the broad objectives of the initiative and are interested in where it might lead, hoping that any change required is proportionate.

MARKET DISCIPLINES

Question 11

Listed companies are subject to the influence of their shareholders, particularly large shareholders and the risk of takeover. What market force is most relevant for mutual life offices? How effective are they in promoting good performance and how might they be enhanced?

The Society is mindful of the influence of its members. Legislation and the Society's rules give rights to members which ultimately could result in the removal of directors, veto significant changes to our business and enable members resolutions to be tabled.

As noted above in the penultimate paragraph of our answer to Q8, members can "vote with their feet" and will be able to do so more easily in the future.

Increasing consolidation in the life and friendly society mutual sector, over many

years, bears witness to the fact that takeover presents a real threat to mutuals. Whilst much of this was driven by management, as stated above our rules allow members relatively easily to propose resolutions, meetings and board nominations thus making merger or takeover possible by this route.

THE POTENTIAL ADVANTAGES OF FINANCIAL MUTUALS

Question 12

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

Question 13

What are the forces that drive demutualisation? What are the implications of demutualisation for members and customers?

A key barrier to the success of mutuals, friendly societies in particular, is the constraint on raising capital. Relaxations in this area would help as in spite of their image, many mutuals are innovative, but innovation (and therefore business growth) is often stifled by capital constraints.

Demutualisation appears to have been driven primarily by the restrictions on mutuals in their ability to raise capital. In addition, in some instances it has been driven by investor greed (ie. the prospect of windfall payments) and, or lack of belief in the values of the mutual model.

A key point is that in a mutual structure the members are the only important people: with demutualisation shareholders need to be satisfied and major decisions regarding the division of dividends, capital reserves and returns to members would need to be taken.

GENERAL GOVERNANCE PRINCIPLES FOR FINANCIAL MUTUALS

Question 14

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?

The primary legislation for Friendly Societies (the 1992 Friendly Societies Act) was introduced at the same time as Sir Adrian Cadbury's report on corporate governance and therefore includes many/most of Cadbury's requirements for effective corporate governance. This includes the requirement for Friendly

Societies to provide annual Section 68 reporting on systems and controls – we believe that non Friendly Society life insurers do not have an equivalent requirement, although perhaps somewhat ironically, for that reason, FSA has recently announced its intention to dispense with Section 68 reporting by Friendly Societies.

MARKET STRUCTURE

Question 15

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

Size is one factor: larger firms should be able to apply a greater level resource to governance, small firms less so.

Equally important however is the issue of business complexity: the scope of business conducted by large firms may be greater, more complex and higher risk than that of smaller firms.

There will also be smaller firms whose scope of business is broad and/or focussed on high-risk products and strategies.

In our view it is not necessarily true to say that governance is stronger in larger firms as many smaller mutuals will be able to demonstrate high standards of governance by virtue of the fact that if their business is simple it should be easier to achieve.

As the impact on investors of default of a larger mutual is likely to be much greater than default of a small mutual there should be greater emphasis on the former in terms of effective governance requirements.

PRACTICE IN OTHER COUNTRIES

Question 16

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 are not aware of governance regimes for mutuals in other countries.

We would be happy to expand further on our comments to this paper should you require.

Yours faithfully,

**Keith Meeres
Group Secretary.**