

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

16 September 2004

Dear Sirs

**Re : Myners Review of the governance of life mutuals**

Homeowners Friendly Society is a mutual organisation and has a direct interest in the outcome of the review into the governance of mutual life insurance offices, currently being consulted upon by Mr Paul Myners. It is from this position of interest that we provide the following responses to the questions raised in section 4 of the consultation document.

**Corporate governance guidance**

*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?*

Homeowners Friendly Society attempts to comply with the spirit of the Combined code, largely on an informal basis.

Certain aspects of the Code could be tailored to suit mutual life offices better, for example the role of a Senior Non Executive Director as a conduit to (large blocs of institutional) shareholders is not "transferable" to the mutual sector. The idea of forming (all of) the Non Executive Directors into a group with explicit responsibility for "policyholder interests", reporting to the members through the Annual Report & Accounts might be worthy of consideration. This should give policyholders a common focus.

The "comply or explain" principle in the Code is completely relevant. In our view, it would be a major error to design a completely different code of conduct for mutuals and proprietary companies.

As suggested above, compliance with the Combined Code could be achieved through the Non Executive Directors reporting to the membership. The report could be scrutinised by the Financial Services Authority who would hold the Non Executive Directors to account for the accuracy and fairness of their assessment.

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

The best way of securing mutual life offices' compliance with corporate governance best practice could presumably be done either by introducing an Financial Services Authority requirement or by way of other complimentary regulation.

### **Board effectiveness**

*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?*

Neither the ownership structure nor the nature of the business conducted by a life mutual should affect the composition or structure of its board. It is worthy of note that although the existence of Non Executive Directors in proprietary companies is voluntary, the Financial Services Authority "insist" on Non Executive Director involvement. This apparent conflict between the two structures should be clarified.

Directors of life companies, whether mutual or not, need to understand the business. This requires training and a thorough understanding of what the technicians do (and how they do it). However, the Directors do not need to be able to carry out the technical work themselves. Directors require little if any additional knowledge to direct a mutual (as opposed to a proprietary) life company. It is not valid to argue that external shareholders in the latter will check that a Board has adequate knowledge of technical matters. This role is covered for both by the Financial Services Authority. Checks to ensure that a Directors knowledge is relevant and kept up to date should be undertaken in the same way as proprietary companies, but could also be covered explicitly through the Non Executive Directors report to policyholders mentioned above.

The nature of the business (whether mutual or not) needs to be reflected in the Board Committee structure. The creation of a "with-profits" committee with reporting to the Board, but no executive owners is a good example. It ensures that the Board retains responsibility for critical decisions, and must therefore possess sufficient knowledge and understanding.

*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?*

As with other technical businesses, the Non Executive Directors rely heavily on the integrity of their executive colleagues. Mutuals are no different in this regard. That said, Non Executive Directors (in both mutuals and non-mutuals) should be prepared to use their authority to call in external advisers to help them review the risk framework of their firm. This could include an assessment of the information supplied to the Board.

*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 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?*

With regard to the role of non-executive directors in complex or technical businesses, the role is no different to any other business. Non-executive directors:

- balance the interests of the members with those of management;
- bring independent judgement to decisions on strategy, performance, use of resources and appointments etc;
- mediate over issues in which executive directors may have a personal interest, such as directors' remuneration, succession and takeovers; and
- monitor performance and ensure sufficient safeguards and controls are in place to protect the interests of the organisation.

In our view Executive and Non-Executive Directors should have exactly the same legal duties to the organisation, when performing their role as a member of the Board of Directors.

Our answer to Q4 is also relevant here. By way of example, with-profits business presents problems that have been widely discussed. However, we should not lose sight of the issues

surrounding long-term non-profit contracts of insurance (annuities, term assurance etc). One of the major problems of the life industry has been the misguided application of complicated actuarial techniques (that were designed to deal with long term contracts) to what are essentially pooled savings arrangements. A radical solution would be to “de-couple” these elements (removing unit linked contracts from the life umbrella and transferring them to the alternative unit trust structure). We would then see much more clearly what risks the life office was really trying to manage. Similar considerations apply to virtually all other businesses.

### **Policyholder voice**

*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?*

Non Executive Directors could report directly to the policyholders. In this report a formal assessment of the skills and various policyholders’ interests could be given. Mandatory policyholder representation on the Board may be difficult because of the nature of the business. However, existing Boards of mutual organisations should not be able to (continue) to thwart the efforts of “legitimate” members wishing to stand for the Board. This could be an area in which the Financial Services Authority could perhaps play a role (eg after Financial Services Authority approval of prospective candidates, the Board would be required to allow members to vote on appointment of the prospective candidate).

A structure involving an “independent reporter” should not be introduced. The governance should be improved within the present system.

*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?*

There is an extra duty of care on Directors of mutuals when considering investment opportunities, because typically the membership is unable to exert the same degree of influence as that which could be exercised by large institutional shareholders.

### **Regulation**

*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?*

The Financial Services Authority has changed its main focus to one of risk based assessment. Prior to 1997, the self-regulatory organisations had not been particularly successful in identifying problems in advance (Equitable Life, pensions misselling, endowment misselling). Our concern is that the Financial Services Authority's risk based approach is likely to mean that they will not tackle governance issues that exist in the large number of small mutuals.

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

As suggested above, the Financial Services Authority could play a role in policing a suitably amended, but compulsory Combined Code.

### **Market disciplines**

*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?*

Non Executive Directors could behave in a similar fashion to the large shareholders of a public limited company, by assuming a role of reporting to policyholders under FSA supervision.

The most relevant market forces for mutual life offices are firstly, the Board themselves, in wanting to operate in the best interests of their membership and acting entirely properly. Secondly, there is the voice of the membership. When combined, these two forces can be very effective in promoting good performance.

### **The potential advantages of financial mutuals**

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

*And*

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

Mutuals do offer a “cleaner” more open and ethical basis for business. The challenge is to take advantage of this opportunity and convert it into a reality for the benefit of the members. The main barrier to the success of mutual businesses in the UK is the lack of access to capital. Can we name even one successful mutual that has been established in the past 10 years?

On the subject of de-mutualisation, our view is that de-mutualisation is explained principally because of the existence of “windfall” profits that encourage current members to accept de-mutualisation. They are “windfalls” because the reserves that are distributed are not truly the assets of the present members (who are truly custodians on behalf of past, current and future generations of members). Additionally de-mutualisation presents an opportunity for the present executive management to benefit from significant increases to their personal wealth (higher remuneration, including shares etc). These phenomena are not peculiar to life mutuals (they have occurred across the entire mutual movement). Therefore it should not be considered for life mutuals in isolation.

The major consequence of de-mutualisation is the assumption that the entire value of the business belongs to the present members absolutely. The concept that (at least in part) the current members are holding the value as custodians for future members fits much better with the mutual principle.

### **General governance principles for financial mutuals**

*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?*

We are not aware of the specific governance arrangements that currently apply to other financial mutuals. Our feeling is that the issues now being considered for life mutuals are probably in advance of those that currently apply to other mutuals. By value, the life mutual sector can be argued to dominate the mutual sector, so there appears to be no obvious reason why the options for life mutuals could not be applied more widely in the financial mutual sector.

### **Market structure**

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

It is a mistake to identify smaller mutuals with affinity groups. There are many smaller mutuals that may have been historically affinity based, but are now “open” firms. For those limited number of affinity groups, governance should be easier to arrange. However, they are not thought to be of sufficient importance to merit a separate regime.

Governance is not directly related to the size of the firm, but to the nature and variety of its business. One of the difficulties faced by the Financial Services Authority is that there are numerous small mutuals with poor governance and complex businesses, but individually they are “low risk”.

### **Practice in other countries**

*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 relevant knowledge of governance regimes for life (or other) mutuals in other countries.

We trust that our response is of interest to you and that if you require clarification on any of the points raised, you will not hesitate to contact us.

Yours sincerely

Andrew Horsley  
Group Secretary and Compliance Officer