

Paul Myners
Review of Governance of Life Mutuals
Room 4/6
1 Horse Guards Road
London SW1 2HQ

13 September 2004

Dear Mr Myners

Independent Review of the Corporate Governance of Life Mutuals -Consultation

The Society's Board has considered your review on the corporate governance of life mutuals and provided its consolidated response to a number of the questions you have posed in the attached document. For ease of reference, the question numbers have been taken from your consultation document.

I hope that our responses are helpful to your consultation process.

Yours sincerely

Ian Ward
Chief Executive

RESPONSE TO THE MYNERS REVIEW ON CORPORATE GOVERNANCE OF LIFE MUTUALS

The Society ensures that its directors come from a wide variety of professional and business backgrounds. It recruits this Board in an open manner and it covers all aspects of the Society's business through monthly committees, which involve representation from non-executives in addition to monthly Board meetings

Question 1

1. In the Society's view, the Combined Code, as presently applied in the entities to which it relates, is a good high level guide to the corporate governance procedures which should be applied in mutual life offices. The Equitable Life problems are identified in the Penrose Report as the result of a number of factors. In chapter 20, paragraph 50, Penrose allocated blame to Equitable Life's corporate governance – "Arguably the first and most significant failure in this report lay at the heart of the Society". However, the word 'arguably' is a major qualification, reducing the sense of the sentence to something less certain than 'in my opinion' and well below the certainty that would have been expressed if no qualification had been inserted. One should not therefore use Penrose to assent that Corporate Governance reform would necessarily prevent any future Equitable Life affair.

Although the Equitable Life Board can be justifiably criticised as Penrose does, he also identified bodies which could have prevented or mitigated the problem but did not do so.

2. The Penrose Report covers a period from the late 1950s through to 2001. The critical period was arguably from 1987 to 1995. Since then:-
 - a) Corporate governance procedures have evolved significantly, a reflection of experiences gained from Equitable Life and other instances where weaknesses in corporate governance were contributory or main causes of a failure of control.
 - b) Many techniques for the identification, analysis, and management of financial business risks were in their infancy in the early 1990s, but have developed considerably since then and their importance has been more fully recognised;
 - c) Other specific responses e.g. by the FSA and the accounting and actuarial professions have been put in place.
3. The appropriate action so far as Corporate Governance of Life Offices is concerned is to leave in place the general Combined Code but to supplement it by industry specific guidance on particular points such as the valuation of liabilities, the monitoring of product design features (especially guarantees and optionality), the potential benefits of splitting with profit funds, and the Board Committee structures for monitoring these.

4. Another approach could be for the FSA, DTI and trade bodies to develop specific codes for mutual businesses. These could be tailored by type (eg life offices, building societies etc).
5. The same principle applied to the Combined Code of 'comply or explain' could be adopted. Indeed the Combined Code would form a good basis for a sector specific code. Features such as length of service for non-executives and their independence and a review of directors' performance etc would apply. However a key difference would be how the relationship with, and equitable treatment of, members should be dealt with by mutual boards. Similarly, the retention of profits for ongoing financial stability would require specific treatment in the Code.

A Code specific to the organisation type would allow boards of mutual organisations 'to know the rules' rather than use, by default, the Combined Code. Such Codes would bring consistency and increase standards of governance. Members would then have a consistent framework against which to make clear judgements of their boards' effectiveness.

Question 2

6. The regulator should:-
 - a) require mutual life offices to make a statement in their annual reports on their compliance with the Combined Code, and
 - b) as part of their review, look behind those statements to see the manner of compliance.

Question 3

7. The Building Society sector (and certainly Leeds and Holbeck amongst others) has established a successful format for a mutual board structure. Fundamental to this is a structure based on a majority of non-executives from a broad section of business backgrounds and at least two executive directors.

It is arguable that the non-financial goals of a mutual organisation can be served by having non-executives from a non-business background. However, in the majority of cases, the pre requisite for achieving non-financial goals is a solid financial base. The non- executives, therefore, need to have the ability to contribute firstly to business success but be of a sufficient character to take account of the non-financial elements and of all stakeholder interests. By exception non-executives may have an alternative background to business.

The Chairman and Nominations Committee hold a key responsibility to recruit suitably qualified non-executives from a broad spectrum of backgrounds and the recent trend to advertise broadly for potential recruits should be adopted.

8. The composition or structure of boards of financial mutuals should **not** be considered distinctly from those of their public equivalents because:
 - A mutual can construct as strong a board as a public company – there are no inherent structural constraints to this and, in the Society’s experience, the mutual nature of the enterprise has not prevented strong candidates offering themselves for consideration by the Nominations Committee.
 - The nature of the Society’s business, the relative transparency of its products and the competitiveness of the market give members (and other customers) significant power.
 - The Combined Code has been developed, which, if applied to financial mutuals, would go a long way to achieving consistently high standards in the mutual sector. Thought might be given to making compliance compulsory or, at least to having a compulsory “comply or explain” statement in annual report and accounts.
- 9 Taking Leeds & Holbeck Building Society as an example, the following illustrates the effectiveness of current Board structures and controls.

The Society reviews the composition of the Board regularly to ensure that it can fulfil all its responsibilities towards Members by:

- Having an appropriate balance by number of executive and non-executive members so that the non-executive voice and influence carries appropriate weight. With two executive members and seven non-executives there is a healthy majority in favour of non-executives with commensurate authority and ability to influence.
- Having a group of non-executives with appropriate skills to enable them to scrutinise and challenge the activities of management as necessary. The Board comprises non-executives with a mix of experiences and professional backgrounds including general management, commercial, legal, retail, financial services and accountancy. The balance of membership is reviewed regularly to ensure it is appropriate and that matters of succession are managed actively.
- Searching for new members of the Board in an open and inclusive way which invites applications and nominations from Members as well as from the general public.

- Ensuring that the personalities and strength of character of the non-executives are such that they have the weight and influence to fulfil their governance responsibilities.
 - Establishing a rigorous Board committee structure with active involvement by non-executives to consider matters in detail on the Board's behalf, with chairmanship by non-executives in key governance areas, including Audit Committee and Remuneration Committee (no executive members of the Committee).
 - Requiring Internal Audit to review the effectiveness of Board's operation with reports directly to the Chairman of the Board and Audit Committee.
 - Complying with the Combined Codes
 - Encouraging non-executive directors to undertake training of a general and specific nature in relation to their duties and subjecting them to annual performance review.
10. In the Society's view, the ownership structure of a mutual life office should not affect the composition or structure of its board. In particular, such a mutual should not take onto its board "member directors" or other tokens of shareholder democracy.
11. The nature of the business of a mutual life office may lead some to believe that 'relevant industry experience' is of greater importance here than in other enterprises. The Society does not concur with that view. All plcs and similar businesses benefit from:-
- a) non-executive directors who have extensive experience at senior management level of complex and well run businesses, who have been selected for their willingness to devote time to their non-executive role and their pre-disposition to perform an inquisitive (but not inquisitorial) role as a non executive, continuous training and assessment of non-executives being features of their subsequent board membership;
 - b) a number of executive directors (rather than the single executive 'chief general manager' of old), most particularly the finance director and the actuarial director, as well as the CEO.
12. Non-executive directors who have spent their careers in other mutual life offices may appear attractive. However:-
- a) they come from a fairly small sector and the dangers of inbreeding/compliance with received wisdom should not be underestimated;
 - b) the presence of such non-executives may lull other board members into a compliant role of following the advice of 'the expert'.

Questions 5 & 6

13. In law, there is presently no difference between the role/responsibility of executive and non-executive directors. We have seen, from Penrose, that an executive director who is not a qualified actuary may claim to have insufficient experience to allow him to assess the proposals brought to the Board by another executive acting as appointed actuary. So, although it may seem unfair or unrealistic in a complex or technical business, each director has to feel capable of challenging the executives, in appropriate cases, on any aspect of the business. If any director feels he/she lacks the ability, time, training, support, boldness or inquisitiveness to do so, resignation may be the only remedy.
14. It may seem appealing to moderate the present legal position so as to allow for the practical limitation of a non-executive director. However:-
 - a) it would be difficult to know where to draw the line (is a non-executive chairman different from other non-executives? What about the non-executive director who feels lack of experience in technical areas?);
 - b) there is a real danger of dividing the board. All directors have equal responsibility to take the business forward as well as to avoid failures.
15. The role of a non-executive is to represent the members' (owners) interests and is the same as for any other company structured to have governance through a board. In the life sector the role of the appointed actuary does (and did) potentially create confusion but this is not a role that is replicated in the financial mutual sector or in the Society.

The non-executive should take steps to satisfy him/herself to the best of his/her ability that the enterprise is being run in accordance with publicly stated plans and policy, and in a controlled and financially prudent manner. In so doing, they naturally have recourse to experts, notably the auditor, pension fund actuary and consultant.

They also have the benefit of industry codes of conduct and the prudential Source Book against which to assess the operation of their own Society.

In addition, the financial sector is well regulated and becoming increasingly so and these regulations, together with the scrutiny of the regulator, provide added benchmarks of behaviour, to which non-executives may refer.

Individually, a non-executive director may not know all technical details pertaining to a financial mutual's activities. However, collectively there should be sufficient knowledge and experience among the non-executives to know when to ask difficult questions, challenge information or lack of it, and seek independent technical opinion/verification when necessary.

Question 7

16. Shareholder democracy in plcs is often criticised as ineffectual, and institutional shareholders are often criticised as lacking a willingness to exercise their limited powers, preferring instead to sell their shares if they are unhappy. However, it is hard to see that mutual life offices can aspire to a greater degree of shareholder involvement than plc's. They should, of course, settle for nothing less.
17. Potential conflicts of interests between policy holders are not fundamentally different from those between holders of different classes of shares or between controlling family shareholders and other shareholders in private and small public companies. There seems to be no easy formula – the board must consider, and in its decisions balance the interests of the company, its shareholders, and other stakeholders. Special interest groups with designated rights/powers would seem an unattractive way forward for the board to be relieved of its responsibilities (and would almost certainly add to them). The use of focus groups to provide information on what would be customers want is a much more attractive approach.

Question 8

18. Lord Penrose is, of course, correct. However, in a life office, which is a plc, there is still a potential conflict between the interests of shareholders/corporate development, and the interests of policyholders/with profit bonuses.

Communication of strategies on such topics to policyholders is essential but this is where the essential problem of “with profits” policies becomes apparent. Transparency is desirable but confidence in the ability of life offices to ‘smooth’ fluctuations in market values requires discretionary allocations, which cannot be wholly objective so transparency may be hard or even impossible to achieve.

Question 10

19. The FSA can stimulate the improvement of firms’ corporate governance. However, this is most likely to be achieved through supplementary, industry specific guidance than through involvement in the Combined Code.

Question 11

20. For mutual life offices, the most important market forces are likely to be product sales, whether direct or through intermediaries. What is required, therefore, is:-
 - a) proper reporting of performance to policy holders;
 - b) removal of the barriers to best advice that can result from up front commissions;

- c) effective monitoring of performance reporting through management controls appropriate board oversight, audit and regulators.

However, absolute success in this area is unlikely to be achieved while with profit policies form a large part of the market.

Questions 12 & 13

- 21. In the UK, unlike most of the rest of Europe, distribution of complex financial products is dominated by independent networks of introducers and IFAs. Consequently, for mutual organisations without any direct distribution, it is the intermediary market share for which they compete and only indirectly the end consumer.

Despite many attempts to reduce the potentially negative impact of this (for example, a focus on commission and other incentives and short term saleability of products rather than their lifetime value or suitability) intermediary needs dominate certain segments of the market. This affects both mutuals and non-mutuals alike but typically mutuals have had a less diversified product offering and have resorted to product competition tactics to win business.

For financial mutuals, with direct distribution through branch networks and post/internet, the impact is somewhat less than for life offices. In addition, mortgage and savings account products, which remain the core of the financial mutual offering, are more transparent than, say, a pensions contract and so the power of the consumer is that much greater, even if they do chose to direct their business through an intermediary.

The other potential disadvantage for a financial mutual, particularly any which strive to run according to prudent financial standards, is their scale. With relatively few exceptions, financial mutuals are significantly smaller than their public company competitors. This means that in a sustained negative environment (whether from a weak market or from intense competitive practices such as 'price wars') the smaller mutuals will suffer loss of market share. In addition the costs of regulation, many of which are fixed, will fall on large and small institutions alike.

- 22. The success of the Leeds and Holbeck and its strong performance versus other building societies, across a number of broad measures and the weaker performance of some mortgage banks represent convincing evidence of how a well run mutual can outperform an institutionally owned business in the mortgage and savings sector.
- 23. The theoretical advantages of mutual structures can be delivered in practice. However, the main barrier to this is corporate remuneration methodologies. Plcs are able to offer share options while mutuals are not. Anecdotal evidence suggests

that mutuals de-mutualise not because of pressure, but because executive directors consider de-mutualisation a good thing.

24. A competitive advantage of mutual businesses in the UK is the free capital provided by reserves (which Equitable Life sacrificed by its 100% allocation policy). A further advantage is provided by the freedom of senior executives from quarterly results meetings with resulting pressure from institutional investors, which may, in the opinion of the board, at times, be contrary to the best interests of members.
25. Generally, the advantages of a mutual structure as identified above, come only after a considerable time and could easily be ended by ventures into major new business areas.
26. De-mutualisation generally leads to:-
 - a) high flotation costs;
 - b) management focus in the pre-flotation process;
 - c) adventurism post flotation – with often sad consequences e.g. Abbey;
 - d) higher executive remuneration.
 - e) Focus on short term earningsNone of the above benefits members/customers.

Question 14

27. Except for industry specific features in the application of the principles of the Combined Code, the Society is not aware of any special governance arrangements currently applied to other financial mutuals. The problems of mutual life offices stem from the actuarial treatment of their with-profits and guaranteed annuity products. Solutions to these problems would be unlikely to be applicable to other financial mutuals whose products are totally different.
28. The long-established capital adequacy rules and accounting standards applied to banks and financial mutuals seem to have created a foundation for prudent management.

General points

29. The Board of any mutual organisation has perhaps to have a greater degree of aversion to risk, because a business owned by its members has by definition an ownership profile that will not understand or indeed accept complex strategies for high-risk high rewards.

30. Oversight is more straightforward and consequently more robust when the goals and objectives of the mutual are clear and are made consistent with prudent financial management. The 'profit' motive is often the subject of debate within the mutual sector. However, it does provide a strong financial discipline to counterbalance the commercial demands on products and pricing from the market. It also provides a healthy basis from which to consider definitions and benefits of mutuality.
31. The central tenet of a board's oversight should be that rigorous financial objectives, policies and limits are in place, reported against and reviewed regularly, backed by disciplined and strong financial resources, with an independent audit function that can be relied upon and a good quality independent auditor to whom the board (via the audit committee) has unfettered access.

Appropriate oversight can then be exercised provided:

- the mutual's goals are reviewed regularly backed by high quality information,
- policy guidelines and limits are set and reviewed regularly,
- internal audit procedures are in place to warrant that the processes and information are accurate and complete,
- performance is reviewed formally and linked to rewards and this subject to an independent Remuneration Committee to determine.

Leeds & Holbeck Building Society

8 September 2004