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

Our Ref:

Your Ref:

Date 28 September 2004

Dear Mr Myners

REVIEW OF THE GOVERNANCE OF LIFE MUTUALS

I have been asked by the Board of MGM Assurance to make a submission to you in response to your consultation document of 9 July relating to the governance of life mutuals.

As you perhaps know, MGM Assurance is a medium-sized mutual office which was founded some 150 years ago. We presently have around £1.4 billion of funds under management. Our constitution extends membership of the Society to holders of qualifying policies which are broadly those which have a component of investment in our with-profit fund. The governance of the Society has evolved over the years in line with good corporate governance practice and we believe that the present Board of Directors is made up of disparate mix of specialists with experience which ranges from actuarial and life assurance management, through accounting and investment experience to more general business knowledge. You have recently forwarded me a detailed questionnaire seeking information into the operation of the Society and its Board and I will forward the reply to this to you separately in due course.

Before turning to the detailed questions for which you request a response, we would like to make one or two general remarks about the governance process for life assurance companies and for mutuals in particular.

Protection of customer regulations

An absolutely key objective for the Board of a life assurer is to achieve a balance between the interests of the owners of the enterprise and those of the customers of the enterprise. Much legislation and regulatory supervision is devoted to ensure that the interests of customers who invest significant sums, often for a long period, are protected in the management of those assets. From time to time there are conflicts between the interests of these two groups and in such circumstances, it is for the Board to oversee the maintenance of equity between the groups. Occasionally disputes have arisen and matters have gone to court. I believe there is a considerable difference here between life assurers and many other commercial and industrial businesses. In few industries are the rights of customers so explicitly policed and the actions of the Board so restricted by the need to refer to customer interests as they are for life assurers.

For a mutual office, the fact that a sizeable subgroup of customers are the owners of the business means that this overt conflict between the interests of owner and customer is avoided. There can still be conflicting interests between groups of customers, as has been seen with the Equitable Life case, but this type of conflict is usually much less significant.

Since the customers of a mutual are already protected by the extensive regulatory regime that ensures fair treatment to customers, such protection applies ipso facto to the owners. We believe this point is somewhat overlooked both in your terms of reference and in some of the remarks of Lord Penrose.

Even without any other corporate governance protections being put in place by the Board of Directors, there is already a significant body of protection in place assuming the correct operation of the FSA regulatory regime and the role of the Appointed Actuary, and soon the With-Profits Actuary.

Different types of Life Assurance Enterprise

The remit of your enquiry draws a contrast between the corporate governance of a listed company governed by the Combined Code on Corporate Governance and by a mutual insurer. However, there are very few listed life assurance companies in the UK market. The majority of life assurance enterprises are either subsidiaries of a larger financial parent or of an overseas multinational. Many of these subsidiary operations have no non-executive nor independent directors.

How many directors of the ultimate parent companies are sufficiently aware of the issues affecting their with-profit funds? Is it not more likely that in such enterprises the problems set out in paragraphs 3.2 to 3.6 of your review will occur than for a closely focused Board of directors of a mutual?

The problem is that, for life assurance, ownership is not simply a concept that applies to shareholders. With-profit policyholders also have ownership rights for their share of the with-profit fund.

We would suggest that it is with-profit life assurance funds (which include a sub-group representing mutual insurers) that need a specific code of corporate governance to protect the interests of their owners (both customers and, where relevant, shareholders).

Turning to your detailed questions, we have restricted attention to those where we felt that we had some opinions to offer that were sufficiently informed to do so.

Question 1. To what extent should the current guidance on corporate governance, particularly the Combined Code, provide an appropriate framework for mutual life offices?

In principle, we believe that the provisions of the Combined Code should also apply to mutuals. This should be subject to some considerations relating to the size of the operation, as is the Combined Code.

However a more holistic regime affecting the governance of all life assurance operations both in relation to owners and customers would be preferable. Such rules could be incorporated into the overall FSA supervisory regime (q.v. question 2.)

Question 3. Should the ownership structure of a life mutual affect the composition or structure of the Board?

It is an important principle of general corporate governance that the directors of the enterprise have corporately, and to a degree individually, sufficient experience, knowledge and training to carry out their functions. This is exemplified in the FSA fit person rules. Individuals who sit on life assurance boards must exhibit the ability and the will to ensure that the operation of the Board as a whole represents the interests of the various stakeholders to whom they have a duty.

The answer to the question is therefore “No”. All boards should face the same issue irrespective of the nature of the ownership.

Question 4. Is the information and advice used by the non-executive directors of mutuals sufficient to enable them to exercise effective oversight of the executives?

This is clearly an issue for all technically complex businesses. In MGM we have addressed this by ensuring that there are technical experts among the non-executives to provide some checks and we feel this is an important dimension to the successful operation of the Board. External advice is also taken.

It is not simply life assurance matters that are technical but also, for example, investment and legal matters. Some non-executives have expertise in these areas also and we regularly seek the validation or at least input from external experts.

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 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?

The answers to questions 3 and 4 above, clearly agree that a successful non-executive must play a role in challenging the proposals coming before the Board (but hopefully not necessarily proceeding from the standpoint that the executives are always trying to hoodwink them!)

A non-executive should be able to identify the key aspects to any proposal and, if they are unable to satisfy themselves of the validity of the recommendations, they should subject them to a more expert scrutiny. Clearly this could result in indecisiveness and ultimately complete stasis, but issues of such complexity and controversy will not occur too frequently.

Question 7. What role should policyholders play in the running of mutual life companies?

As we have remarked above, this issue applies to all life companies with with-profit funds not just to mutuals since, for such companies, the with-profit policyholders also have ownership rights.

The obvious barriers relate to knowledge and experience. It is difficult to obtain non-executives with the right balance of these attributes. Individual policyholders will rarely have sufficient expertise. However in principle such a development is to be welcomed.

The new With-Profit Actuary regime will create an individual who occupies some of this ground, with explicit representation of the policyholders in his remit.

Specifically you ask what role should the Board play in ensuring equity between different groups of policyholders. For a mutual this is an absolutely fundamental concern. The management of the free assets of the mutual, and the resulting declarations of surplus, is at the heart of the financial planning of the whole enterprise. The annual Financial Condition Report, which has been prepared by the Appointed Actuary for consideration by the Board of Directors, is specifically addressed at these issues. Although the matter is inevitably subject to a degree of subjectivity and is undoubtedly a complex area to comprehend, it is essential that the Board, and indeed individual Directors, should be wholly familiar with the issues and able to form a reasoned view of the treatment of such groups.

Question 8. "It is the policyholders who provide the risk capital". What does this mean for the relationship between a mutual life office and its policyholders.

It appears that the remarks made by Lord Penrose oversimplify the issue. The risk capital of a business at a given time has actually arisen from three sources:

- a) current with profits policyholders to the extent that surplus created from their policies has built up and not yet been attributed to them as bonuses;
- b) historical generations of with profits policyholders who no longer are policyholders from whom surpluses were created, but for a variety of reasons were not distributed;
- c) profits from other sources which are not directly attributable to a specific group of with-profit policyholders; for example, profits earned from non-profit policyholders or windfall investment profits.

In cases b) and c) above, there is a real issue as to the rights of current generations of policyholders to own these surpluses. This is often at the heart of "orphan asset" cases. For a mutual, the Board must decide on whether to release such money and at what speed, or alternatively to use it as the base for future development of the business. Furthermore it is possible to derive risk capital by other means altogether; for example, through borrowing of various kinds. This can itself give rise to unattributable profits or losses.

In recent times, and particularly looking forward to the regime postulated by CP207, it is clear that the risk capital actually provided by future generations of with-profit policyholders will be very limited. The proposed rights of individual policyholders to own their own particular piece of the pot (in the form of 100% of unsmoothed asset shares) also has the perhaps unintended impact of restricting the amount of "miscellaneous surplus" with which they can be credited. In our view, this is too prescriptive a regime and strikes at the heart of the objectives of mutuals. If implemented, even in its present modified form, it may well remove the *raison d'être* of mutuals altogether and simply render them obsolete.

In summary, there is clearly a different relationship between a mutual and its policyholders. This is obviously a much closer one and one that has greater alignment than for a proprietary company. However the removal of the potential conflict with shareholders brings to the fore issues of conflict between generations and perhaps between with-profit and non-profit policyholders. The issues that arise are very often the same, but simply with differing groupings involved.

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 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? and

Question 10. Is there a further role for the FSA to play in improving firms' corporate governance?

We would definitely agree that the new regulatory regime has provided significant explicit strengthening of the corporate governance regime and this is particularly so for mutuals. The introduction of PPFMs, the revision of the actuarial oversight and the introduction of the With-Profit Actuary role, and also the use of With-Profit Committees to aid the decisions of Boards, are all very positive improvements in governance. Going further, the introduction of greater emphasis on risk management and risk-based capital, with the use of realistic reporting, has also strengthened the underlying financial protection which will apply to life assurers.

Our view is that this regime now needs time to bed down and for the subsequent phases such as ICAS to be implemented without further changes. The fact that the proposals are not altogether completed is unfortunate (for example, the failure to conclude the CP207 Treating Customers Fairly proposals). There has been major change in these areas and the changes should now be digested and perhaps refined, but not subject to further development and definitely not retracted until they have had time to be tested.

Question 11. What market forces apply to mutuals – how effective are they in promoting good performance?

Market forces undoubtedly play a great part in the operation of mutuals. The large number of demutualisations during the last 10 years in the UK is testimony to this. There has been just as much change among mutuals during this time as for proprietary offices - indeed probably rather more. It is probably still possible for very small niche mutuals to allow the real world pass them by in the same way that there are still a small number of corner shops. But for the larger mutual offices, the forces of change that have swept through the life and pensions market have meant profound change. The demise of confidence in with-profits, the crisis in pensions, the lack of confidence in long-term investment by the public at large, the flight to quality of major intermediaries - these forces all have a huge impact on all of us.

For mutuals, the risk of takeover has a parallel with the risk of demutualisation or the potential of a merger with another mutual. These are subject to somewhat different drivers, but are every bit as real to a mutual company as takeover is to a listed company. The events at Standard Life over the last year or two are prime examples.

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?

In some of the preceding answers we have made reference to CP207 and its detrimental impact on mutuals. This is the subject of continuing consultation by the FSA, but even the present revised proposals could well herald the end of life assurance mutuals. This is largely due to the rigidity of the treatment of with-profits business going forward. Should the proposals proceed to implementation, mutuals will either cease to exist or will need to reinvent themselves.

Mutuals have an inherent attraction to the public. The idea of sharing in risk and mutually benefiting is a well rooted one and indeed is at the heart of all insurance. In recent years this positive view has declined in the UK, but it remains very strong in Europe. I believe that this is primarily due to the prevalence of short-termism. Despite the fact that mutuals have over a long period tended to produce better results for their policyholders than proprietary offices, this long term potential benefit has become less persuasive to the investing public. Many demutualisations were little more than taking the jam today at the expense of tomorrow. These drivers have not been seen in Europe, where the more long-term view of investment purpose still prevails.

Clearly damage has been done to the long-term investment scene in those markets where the investors are the most risk-taking. Probably, in order, this is US, UK, Canada and Australia; precisely those markets where demutualisations have principally occurred. Damage has additionally occurred in the UK due to the mis-selling scandals and from the high profile problems of Equitable Life.

Questions 14 to 16 are not directly applicable to MGM Assurance.

To summarise our position, we believe that a well-governed mutual life assurer with a well-constituted Board of Directors is likely to be as well run for the benefit of its owners as a proprietary company. This is due to two reasons; the lack of conflict between owners and policyholders and the direct focus of the Board on the issue of managing the with-profits fund. There is always scope for improvements in governance and we would have no issue with an extension of the provisions of the Combined Code to mutuals. However we would prefer to see these extended to all life assurance enterprises, including subsidiary companies, where there is a with-profit fund. We are not in favour of further extensions of life assurance regulation, but believe that existing change proposals should be allowed to settle in.

In general, we would like to see real support for long-term savings in the community from both Government and the regulators. In particular, this is not aided by a continued and continual reappraisal of past shortcomings. We must all look forward.

I hope that these answers to your enquiry are helpful and we look forward to your detailed findings in due course.

Yours sincerely

Gerard Healy
Chief Executive Officer