

# The Governance of Mutual Life Assurance Companies

submission to the Myners Review of Mutuals <sup>x</sup>

from Stephen Wynn

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## 1. Affinity groups

Mutual insurance companies should be associated with affinity groups. Friendly societies always seem to be associated with affinity groups, but these may be so general such as Homeowners and Family Assurance, that this is not meaningful. You do not even have to be married to become a member of Family Assurance.

Equitable Life was formerly associated with university teachers. The Penrose report <sup>x</sup> discusses the history of Equitable Life:

"3. Until the early 1970s the Equitable Life was a relatively small, conservative life office serving a narrow market. The bulk of its business was generated by the FSSU, an endowment based scheme for university teachers that required little in the way of marketing and management, and was of its nature aimed at an intelligent and articulate clientele. This appears to have insulated the Society from general competitive pressures."

What affinity groups exist which could have their own financial institution? All new babies is an example of an affinity group. I recommended that a new organisation should be set up to administer Child Trust Funds, in a submission to the Treasury Committee. <sup>x</sup>

Employees of particular industries is another affinity group. The Parliamentary Industry-Wide Pensions Schemes Group says in a memorandum to the Select Committee on Work and Pensions:

"The real issue that holds back industry-wide provision is the Inland Revenue's concern that there should be no cross-subsidy between competing enterprises." (3.5) <sup>x</sup>

This seems an interesting point but the memorandum does not contain references and I have not been able to follow it up.

The consultation document of the Myners Review always uses the term "affinity group" in conjunction with the adjective "small". But such groups need not be small. For example employees in Denmark have the ATP scheme which has 4.3 million members (at end 2003). The ATP board is appointed mainly by "parties to the labour market", employer and employee organisations.

The ATP website says: "ATP's investment expenses are low - even by international standards." <sup>x</sup> In the year 2003:

"Pension activity expenses amounted to DKK 32 per member, while investment activity expenses were DKK 20 per member." <sup>x</sup>

The 2003 accounts give an expense ratio of 2.1% not of capital per annum but expenses as a percentage of premiums.

## 2. Governance of mutuals

Q15 of the consultation document asks: "Do small, affinity group based, mutual life firms face different governance issues from the largest firms in the sector?" An advantage of being associated with a group is that the mutual company can be controlled by the group rather than being free-standing.

Q7 asks: "What role should policyholders play in the running of mutual life companies?" There are various problems with such involvement of policyholders.

Proprietary companies often have some large shareholders, in comparison with the large numbers of policyholders of mutuals each with one vote.

Policyholders of mutuals tend to follow the advice of management because they do not want to rock the boat. Voting against the wishes of management makes them nervous. This is a reason for the large yes vote for the Equitable Life Compromise Agreement. Policyholders tend to be much more timorous than shareholders. Policyholders seek security, and have no wish to be "investors".

Policyholders are in general not active investors, because active investors buy shares rather than policies. But for policyholders to have a role in the running of mutual life companies they need to be active. The Equitable Members Action Group (EMAG) <sup>x</sup> was founded in 2000 only after it was clear that Equitable Life was in difficulties.

According to the Oxford English Dictionary "saving" means "keep for future use", and "investing" means "apply for profit". "Investors" take a more active interest than savers, especially where their money is invested. Policyholders are arguably in general savers rather than investors. They have no wish to be either investors who take an active interest in their investments, or consumers who shop around. Yet the FSA uses the terms "investor" and "consumer" much more frequently than "saver". <sup>x</sup>

To be influential policyholders of mutuals need to have strong representative organisations such as EMAG in the case of Equitable Life. This has its own problems, such as whether or not an organisation is recognised by the mutual. Of late Equitable Life has been recognising the Equitable Policyholders Action Group rather than EMAG. <sup>x x</sup>

## 3. Conversation stoppers

Membership of the Danish ATP scheme is compulsory for employees, and optional for other people such as the self-employed. At the mentioned of the word "compulsion", I find that people tend to say "the government will never agree to compulsion". This is claimed to be an insuperable obstacle and conversation ceases.

I do not think that compulsion is necessary if there are sufficient incentives to be a member, or remain a member that is not to opt out.

It is often the case that by not joining an occupational pension an employee loses an employers' contributions, which is a strong incentive to join.

An example is The Thrift Savings Plan for Federal employees in the US. I like this example especially because like the Danish ATP scheme information is readily available on the web.

"Your agency will start to contribute Agency Automatic (1%) Contributions to your account. If you are contributing your own money, you will also receive Agency Matching Contributions." <sup>x</sup>

Another conversation stopper is that savings would become too concentrated. A contributor to a discussion on the website of the Investors Association comments:

"IA member Stephen Wynn would prefer the average citizen's money to be invested in a collective government backed investment fund to reduce obscene charges and improve investment returns.

I don't agree with this diagnosis. Charges can be reduced within a diverse private sector. If all of our savings are channelled into the same place this could have profound and dangerous implications." <sup>x</sup>

I have not proposed a "government backed" investment fund. "Charges can be reduced". They can also be increased! For example, the annual management charge of stakeholder pensions has just been increased from 1% to 1.5% for the first 10 years. I am not suggesting "all of our savings are channelled into the same place". It depends on how large are the affinity groups and how the funds are invested.

People usually use the expression "too powerful" with the same meaning as "dangerous". But the alternative is weak consumers. The Sandler Review constantly complains about "weak consumers".

"The root cause of the problems in the retail savings industry is consumer weakness." (10.89)

A further conversation stopper is: "The government would not set up new mutual organisations." The Danish ATP scheme mentioned above was set up by parties to the labour market, with supporting government legislation. Mutual organisations should be set up by affinity groups rather than the government.

#### **4. "Got at by entrepreneurs"**

The employees of a mutual such as Equitable Life are working for a business in the first instance not for policyholders. They need the business to be successful to stay in a job. A contributor to the Equitable discussion on the Motley Fool website said:

"Mutual managements have had many years of experience in dealing with unwanted resolutions and have no compunction in turning any errors made against naive members who try to challenge the managements's 'right to manage' (that is how they think of it).

Mutuals are not the cuddly, policyholder friendly, fair-minded institutions that some people on this board think they are. They are run by hard nosed businessmen who regard their own survival and the feathering of their own nests as priority number one, way behind any supposed 'rights of' or 'duties to' members." <sup>x</sup>

Equitable Life is reported to have described the industry as "got at by entrepreneurs in the 1970s". <sup>x</sup> Jim Cousins MP said at a Treasury Committee meeting:

"Meanwhile, back in the wholesale financial markets, we now find that we have soft commissions, improper connections between analysts in some of their other activities, we have late trading, share ramping, insider dealing, short selling ... We have a market that makes kickboxing look like the Bells on Sunday! " <sup>x</sup>

Competition is not effective in reducing charges to acceptable levels. The President of the Institute of Actuaries said: "competition actually increases commission in the insurance business." <sup>x</sup> When the Maximum Commission Agreement was abolished commissions increased. <sup>x</sup> As discussed on my website the FSA is constantly talking about the disclosure of information but wants hidden charges to remain hidden. <sup>x</sup>

Selling "products" to anyone through financial advisers results in a general free-for-all. For example John Chapman said in an article in the Financial Times:

"When the government abolished a maximum commission agreement in 1990, the influx of salesmen was such that it was calculated that by 2000 half the country would be selling policies to the other half. That led to the pensions mis-selling scandal. The then FSA chairman Sir Howard Davies commented that the growing endowment scandal was also a consequence of the commission culture." <sup>x</sup>

It would have been better for the public if mortgage endowment policies had not existed since it is currently estimated that a rising 80 per cent of policies do not repay mortgages as promised. The same applies arguably also to other savings "products" such as split capital investment trusts, and precipice bonds.

## **5. The interests of non-policyholders**

The consultation document of the Myners' Review refers to "policyholders' interests". But what about the interests of non-policyholders? A non-policyholder might become a policyholder and then regret it, such as one customer of the Portman building society:

"Counter staff suggested she saw a financial adviser from the Portman. But what Mrs Greenep did not realise was that this financial adviser

did not work for Portman at all. He was employed by Portman Financial Services - a wholly-owned subsidiary of insurer Norwich Union." <sup>x</sup>

If a mutual organisation is associated with an affinity group, people outside the group cannot become members or at least the organisation does not have to promote itself outside the group. If someone regrets having bought a policy requiring regular premium payments, these will cease. Persistency rates are given in the report of the FSA *Stopping short: why do so many consumers stop contributing to long-term savings policies* by Sarah Smith. <sup>x</sup>

"We estimate that the average contribution period for a regular premium 25 year personal pension is probably in the region of ten years." <sup>x</sup>

Penalties are greater when policies are surrendered. John Chapman says:

"But it was not until the publication of the Asset Share Survey 2000 by consultants Tillinghast that I realised how widespread the secret practice of surrender profits had become. Two-thirds of companies were lopping 10 per cent, 30 per cent or more off surrender values to boost much publicised maturity values achieved by a small minority of policyholders. This had nothing to do with the smoothing described in with-profits guides, and the secret rip-offs may amount to the biggest uninvestigated fraud ever." <sup>x</sup>

I have not been able to find the Asset Share Survey 2000 on the Tillinghast website. Surrender profits are discussed in an article *The incredible shrinking surrender value* by John Chapman in the September 2004 issue of Money Management which starts:

"Millions of policyholders have lost significant proportions of their savings through the secret cutting of with profits endowments' surrender values and the transfer and paid up values of pension plans. Each year as much as £1bn pounds of surrender profits has been switched by weaker companies to match the maturity payouts of market leaders. But this potential scandal has not attracted the attention of the regulators.

The FSA is instead papering over the cracks by getting companies to produce complex Principles and Practices of Financial Management (PPFMs), astonishingly institutionalising surrender profits,"

In its report *Standards for retail financial products* (2001) the Treasury states: "In the modern world people will increasingly need to look after their own financial interests for themselves." (paragraph 15). <sup>x</sup> The Minister, Ruth Kelly, said:

"The objective of regulation is not, therefore, to provide total or near total assurance to investors. Rather it is to provide reasonable standards in the sector which provide a framework within which investors can take their own judgements." <sup>x</sup>

The government wants to turn everyone into "investors" and "consumers" of financial services and "products" who make "informed choices", have "responsibility for their own decisions" and "shop around". Rather than seeking to pool risks the government is offloading risk and responsibility onto individuals.

## 6. The wrong side of the fence

The funds of life assurance companies are increasing relative to those of pension funds.

**Assets of institutions (£ billion)**

year (end)	unit trusts	investment trusts	insurance companies	pension funds	% pension funds
1993	88	29	434	480	46.6
1998	163	47	776	699	41.5
2000	223	60	933	765	38.6
2002	190	38	854	610	36.1

Source: *Financial Statistics*, ONS <sup>x</sup>, April 1966, April 2000, September 2002, August 2004.

"Pension funds" in this table refers to the funds of occupational pension schemes. They are comparatively inexpensive to administer. The pensions green paper *Simplicity, security and choice: working and saving for retirement* (2002) reports:

"for the largest schemes (those with over 40,000 members), the average administration cost is around £ 28 per member a year. For smaller schemes (those with fewer than 500 members), the cost is around £ 80 per member a year." (page 129, paragraph 10) <sup>x</sup>

This is much lower than a 1% of capital per annum management charge. Expense ratios, that is expenses as a percentage of premiums, are stated to be in the range 52 - 118 % for 14 insurance companies in 2003 in *Money Management* (September 2004, Table 5, page 25), and in the range 27 - 251 % for 23 companies in 1993.

Annuities are not an efficient way of providing a pension. But the ABI says that: "Annuity sales are set to increase dramatically over the next ten years and beyond," <sup>x</sup> Calculating from Prudential annuities for men, I estimate that about 15% of premiums are absorbed in charges irrespective of the age at which the annuity is bought. <sup>xx</sup>

The expectation of life of a man aged 60 is 20 years. If an annuitant lives for exactly 20 years, then the capital is absorbed if 5% is paid out per annum. But the annuity rate for a man aged 60 is 6.5. This leaves only 6.5 - 5 = 1.5% as investment income.

There is a mismatch between how annuity income is provided in practice and how it is calculated by actuaries. Insurance companies pay annuities out of investment income rather than reducing capital. Long-term interest rates are about 5%. Thus the 5% in practice comes from interest rates rather than reducing capital. But if annuities

are paid out of income then the capital of annuitants who die can be distributed to the living producing an income which is the reciprocal of the expectation of life namely  $1/20 = 5\%$ . Adding another 5% for investment income produces a larger pension than produced by the annuity calculation, because capital is not declining. But this implies the existence of reserves.

The mutual insurance companies which are the subject of the Myners Review sell annuities. They are on the wrong side of the fence, in the sense that pensions should be provided by pension schemes rather than annuities. Pension schemes are able to build up reserves and pay a larger pension because they do not need to use the annuity calculation which assumes declining capital. Insurance companies build up reserves and orphan assets. Such surplus funds can be used by pension schemes to pay more generous pensions, but insurance companies have to pay the less generous income resulting from annuity calculations.

As constituted at present mutual insurance companies are on the side of the fence where policyholders have to pay high explicit and hidden charges, where companies can be "got at by entrepreneurs" are part of the "commission culture" and part of a market which "makes kickboxing look like Bells on Sunday".

The Myners Review has resulted from the Equitable Life scandal. This was caused by inadequate reserves. Not building up reserves gave the company a competitive sales advantage, because it could declare larger bonuses. This leads on to the general topics of reserves, orphan funds and closed funds. The lessons of the Equitable Life scandal are wider than the issue of corporate governance which is the topic of the Myners Review.

In addition to being able to provide a pension rather than requiring members to buy annuities large collective schemes based on affinity groups have further advantages:

1. The scheme does not need to employ salesmen to recruit members.
2. Members of the group do not have to concern themselves with shopping around, gathering and reading information, comparing "products", coping with complexities, negotiating charges etc.
3. There are economies of scale.
4. The scheme has more negotiating weight with the financial services industry than individuals.
5. Tasks can be performed in-house rather than requiring the services of the financial industry, and schemes are able to employ people who are more knowledgeable than individual members - reducing the likelihood of mistakes.
6. Insurance provided collectively for all members of a group is inherently cheaper than when purchased separately by each member.

7. A mutual institution based on an affinity group is less likely to demutualise than one which is not based on an affinity group.

## 7. "Improvements"

This subject is going round in circles. As Jim Cousins MP put it:

"Yes, we have partnerships and strategies and stakeholders and working groups and important meetings here, there and everywhere." <sup>x</sup>

There is continual talk of "improvement". For example the report of the Treasury Committee *Restoring confidence in long-term savings* (2004) <sup>x</sup> contains the words: "improve financial literacy", "the industry can make substantial improvements on its own initiative", "improve the investment performance of the long-term savings industry", "improved transparency", "improve the efficiency of the industry", "a study programme of improvements", "the regulatory environment had improved", "a significant improvement in the regulatory framework", "a significant improvement in the protection afforded to the consumer", "improve coordination between the FSA and FOS", "it would be useful for the FSA to improve its communication with", "work to improve consumer education", "work on improved financial capability", "work on improved consumer understanding", "improved awareness of financial products", "improve performance in the conduct of business", "improvements taking place in one sector", "improve the quality of service", "we welcome recent improvements", "improve on the FSA's requirements", "put additional pressure to improve efficiency on the industry", "a significant improvement in the protection afforded to the consumer", "improved consumer understanding", "we welcome recent improvements".

I am disappointed that the Treasury Committee did not discuss or even mention the topic of hidden charges in its report, although I had brought this to its attention in my submission on Child Trust Funds.

The Myners Review seems likely to result in improvements in the governance of mutual life insurance companies. All these improvements do not change the underlying reality that companies are looking after savings as a business and competing with each other to gather in savings. This results in a business model for the financial industry which is inconsiderate, one-sided, unstable, and with serious conflicts of interest. <sup>x</sup> There is a need for a new approach based on affinity groups rather than just endless "improvements".

What happened as the result of the previous Myners Review *Institutional Investment in the UK* (2002)? <sup>x</sup> An article in the Guardian reports that not much is happening:

"It is the destiny of most reports into the financial services sector to burn bright on their day of publication, then gather dust and be quietly forgotten... Critics will argue that few have had any long-term impact, although that does not damn their authors; it's rather more to do with the City's expertly honed skill at chipping away at unwanted reform." <sup>x</sup>

The slow progress of the recommendations in the previous Myners Review for the disclosure of stockbroker commissions and soft commissions is discussed on my website. <sup>x</sup> Paul Myners said to the Treasury Committee on 22nd January 2004 about these proposals in his report:

"I have a fear that that has run into treacle and that it is not being taken through to the logical conclusion of obliging, through regulation, the unbundling of commissions and the ceasing of under-disclosed kick-backs." <sup>x</sup>

## **8. Conclusion**

There is a need for a different general approach which is based on affinity groups. Everyone should be a member of a group. Even if an affinity group does not have its own insurance company, members can benefit because the group can negotiate better terms with existing companies. <sup>x</sup>

There is a need to identify and encourage affinity groups which might have their own financial institution. Such as employees in the English regions, Scotland and Wales who work for employers who do not have an occupational pension scheme.

A further affinity group are employees of particular employers or industries. This is rather untidy in comparison to regions because there are so many different different employers and industries. <sup>x</sup>

The Myners Review of Mutuals and the report of the Treasury Committee on restoring confidence in long-term savings seem to be part of a system for offloading risk and responsibility onto individuals.

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