

Myners review of the governance of life mutuals

Final report

December 2004



HM TREASURY



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governance of life mutuals**

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FOREWORD LETTER FROM PAUL MYNERS TO STEPHEN TIMMS

I attach a copy of this Review's final report.

I believe that by instigating this Review the Government has been the catalyst for some important changes in the mutual life insurance sector. In particular there are now many in the sector who are clearly convinced of the merits of embracing good corporate governance practice both at the individual firm level and collectively. This is a vital step all firms must take if they are to command the continuing trust of their customers and foster a positive view of mutual life insurers in general. The establishment of the Association of Mutual Insurers (AMI) and the work they have done to date is evidence of this new impetus to work towards common industry goals.

My recommendations, if taken forward, will help provide some form to the industry's aspirations and a focus for a process of continuing development and improvement in corporate governance practice across the whole sector, raising all to the standards of the best. I hope they will also provide the foundations for a renewed confidence in the mutual concept in this sector and the specific benefits that it can bring, in the right circumstances, in terms of customer focus and adding to the diversity of the financial services market.

At the heart of the Review's analysis is the message that a mutual life office is no different from any other type of enterprise in needing good governance. Governance provides the checks and balances to ensure that firms are run efficiently and meet the objectives of their owners, whether shareholders or the members of a life mutual. In formulating the Review's recommendations, I have also recognised that risk is inherent in the conduct of business, and necessarily so. Just like their proprietary counterparts, life mutuals are in the business of taking risk in a competitive market. Good corporate governance can ensure those risks are identified and appropriately managed, but it does not eliminate them, and it should not be believed that it does. Indeed measures that sought to eliminate risk could destroy the very purpose of these entities.

Life mutuals have a unique structure with a clear focus on delivering benefits to their members. They also face a number of specific corporate governance and accountability issues as a result of their particular form of ownership and the nature of the business they conduct. The Review's assessment is that governance is already good in some life mutuals, but also less good in others.

With these considerations in mind, the recommendations in the report address the issues in a realistic and proportionate way, and are rooted in established practice and common sense. Taken together, they provide the basis for life mutuals to ensure that their accountability will be enhanced and their governance will compare very favourably to best practice in comparable proprietary companies.

A major theme of the report is the view that good corporate governance is not just about what goes on in the boardroom. A firm cannot be well governed if it accounts to no-one. I have, therefore, developed a number of recommendations designed to clarify and enhance the accountability of life mutual boards. At the centre of this is the way that firms relate to their members and the flow of information they make available to their members and to other observers and market participants. In doing this, I recognise that members do not have the resources or the incentives of large shareholders. They are nonetheless uniquely placed to exercise oversight of life mutuals from an owner's perspective, and I urge them to engage in that process. In addition, the Financial Services Authority (FSA) has made considerable strides in recent years in recognising the importance of good corporate governance to good regulation, and reflecting this in its style of supervision. I hope it will take into account the lessons from this Review as it further develops and refines its approach.

The Combined Code on Corporate Governance,¹ although directed at listed companies, provides universally applicable corporate governance principles of separation of function, independence and transparency and translates them into guidance on good practice. I am clear that these principles, as enshrined in the Code, also provide the right basis for good corporate governance among life mutuals. At the same time it is important to

¹ <http://www.frc.org.uk/corporate>

acknowledge the many very specific attributes of life mutuals and the particular environment they operate in, and what this means for how the principles are interpreted and implemented. Accordingly, one of my main recommendations is that all life mutuals should adhere to an annotated version of the Combined Code, which interprets, for the benefit of life mutuals, the principles and provisions enshrined in the Code.

The role non-executive directors can be expected to play in a complex business such as life insurance has arisen repeatedly during the Review's consultation process. It was also the subject of some interesting observations by Lord Penrose in his report into Equitable Life². The report recognises that, in life mutuals, non-executives face particular challenges. My analysis, however, is that these are not insurmountable, and this report provides some principles for success in life mutual governance to assist non-executives in their task. There also needs to be clarity around corporate purpose and the respective roles of non-executives and the executive. A major issue in this context is the difficulty of defining clearly what success means in the mutual context. The report aims to open up discussion of this issue. In addition, a thoughtful approach needs to be taken to recruitment, ongoing director development and board appraisals. Non-executives also need appropriate information and pro-active support if robust debate is to take place in the boardroom. Ultimately, however, the main task for non-executives is to ask the right questions, and if they are not satisfied by the answers, to ask again and again. These observations, while rooted in the particular circumstances of life mutuals, may be of some value to other types of organisation, in the public, private and voluntary sectors.

I am given hope by the many people I have met during the course of this Review, and the many written submissions we have received, that my main recommendations will command wide support among industry participants, their advisors, commentators and members. In particular, the majority of respondents to the Review's consultation document acknowledged a need for more corporate governance guidance for the life mutual sector, as well as supporting steps to make corporate governance requirements binding. Respondents were also in favour of promoting greater engagement of mutual members.

I hope that most of these recommendations can be set in train quickly. The recommendations and the thinking behind them are highlighted throughout the report. A complete list is to be found in Chapter 2.

I have not recommended legislation at this stage. I believe that it is appropriate first to seek voluntary adoption of my recommendations to avoid what would be a considerable legislative effort, the costs of which might prove disproportionate to the potential benefits. This calculation is informed by my clear understanding that many of the recommendations in the report can and will be taken forward voluntarily by mutual life offices and their trade bodies, supported by supervision by the FSA. I have however recommended that the situation be kept under review by the Government.



Paul Myners

² "Report of the Equitable Life Inquiry", March 2004, available on the Treasury's website, www.hm-treasury.gov.uk

INTRODUCTION

PURPOSE OF THE REVIEW

1.1 The terms of reference of this Review are to:

“Consider the governance framework for mutual life offices in comparison with that for comparable companies (and, where relevant, for listed companies).

Where appropriate, bring forward recommendations to ensure that boards of mutual life offices are as accountable to their members as boards of comparable companies are to their shareholders.

As part of this, the review will examine:

- *The level of member involvement in the governance of mutual life offices;*
- *Board accountability for mutual life offices; and*
- *The level of regulation by the FSA to which mutual life offices are subject.*

The review will consult as widely as possible, taking into account the recent experience of other mutuals in this area in developing its conclusions and recommendations.

Since the governance of mutual life offices has much in common with that of other mutual societies, where appropriate, the review may also develop general governance principles for other types of mutual (taking into account the particular characteristics of other parts of the mutual sector).

The review will deliver a report with recommendations by the end of 2004.”

1.2 The Review was announced following the publication of Lord Penrose’s report into events at Equitable Life. When the then Financial Secretary, Ruth Kelly, announced the Review in March she recognised that the problems at Equitable Life arose as a result of the particular circumstances in place during the inquiry period, but noted that the report nonetheless raised some questions for the governance of mutual life offices in general. A summary of Lord Penrose’s findings on this subject is at Annex A.

1.3 Consistent with the terms of reference, my intention in conducting this Review has been to learn the lessons from the Equitable episode and Lord Penrose’s observations on it, but not to be confined to the particular set of events and the issues it raises. My approach has instead been to look closely at corporate governance practice within the sector, to learn about how life mutuals work, and envisage, in the light of that, how corporate governance best practice might operate in such an environment.

CONDUCT OF THE REVIEW

1.4 I very much welcome the opportunity to lead this Review. I would like to thank the many people and organisations who have contributed to it. We have received substantial input from a large number of people in the life insurance sector, academics, commentators and others. I am extremely grateful to them all, and for the very constructive way they have contributed to the debate. I would also like to record my most sincere appreciation to the team at the Treasury, led by Lowri Khan and including Paul Coombes, a former director of McKinsey & Company, who have supported the

Review. I am indebted to Lowri and her colleagues for the clarity of their analysis, enthusiasm and industry.

1.5 The Review has been conducted in an open and collaborative way. The Review's consultation document was sent to over 250 people and organisations including trade associations, consumer groups, mutual and proprietary life companies, academics and advisers to the industry such as accountants and actuaries. We also invited the larger life mutuals to make the document available on their websites. We received 73 written responses and where possible we have published them on the Review's website¹. This is only part of the picture: we have met many more people in meetings, visits and in a series of round-table discussions. I hope that all those who contributed will recognise their input in this report.

OVERVIEW OF THE REPORT

1.6 The main body of the report starts in Chapter 2 with a summary of the Review's main findings and recommendations.

1.7 Chapter 3, "The UK life insurance industry", provides by way of context a brief overview of the life mutual sector in the UK today, its constituent elements and principal characteristics. It discusses the meaning of mutuality in the organisation of economic entities.

1.8 Chapter 4, "Governance in UK life mutuals", explores what we mean by corporate governance, what its main purposes are, and why achieving good standards of corporate governance is important. It also looks at corporate governance practice in the mutual life sector today, drawing on research commissioned by the Review.

1.9 Chapter 5, "What makes life mutuals different?", considers from a theoretical and practical perspective the differences between life mutuals and comparable proprietary companies and the implications this has for determining what corporate governance arrangements are appropriate to the particular circumstances of life mutuals.

1.10 Chapter 6, "The mutual advantage?", considers some issues around mutuality, and the purposes of corporate governance in that context.

1.11 Chapter 7, "The role of the FSA in corporate governance", explores in more depth the role that the regulator plays in monitoring life mutuals, its recent initiatives in the regulation of life insurance and what role it might play in the future.

1.12 Chapter 8, "The role of non-executive directors", takes a closer look at the part played by non-executive directors in a life mutual, drawing on research by the Review team as well as consultation responses. It builds on this to set out some outline principles for success in life mutual governance.

1.13 The principal recommendations of the Review are to be found in Chapters 9 and 10. Chapter 9, "The effective board" considers the case for a Combined Code tailored to life mutuals, and how adherence to such a Code could be promoted (including the role of the FSA). It also explores a number of the key issues that emerged from the consultation process, in particular about board balance and independence, board structure and committees, skills, and support for non-executive directors.

¹ www.hm-treasury.gov.uk/myrners

1.14 Chapter 10, “Accountability”, looks at enhancing the external influence on the board of a life mutual. It advocates best-practice guidance on involving members and discusses options for facilitating greater external scrutiny of firms, primarily through encouraging greater information disclosure to members and market participants.

1.15 The final chapter, Chapter 11 “Concluding remarks” describes how the Review envisages its recommendations being taken forward, and considers the consequences of this Review for other types of mutual organisation.

2

SUMMARY AND RECOMMENDATIONS

2.1 The mutual life sector is an important feature of the UK's financial services landscape, providing a home for the savings of nearly 10 million members and managing funds of over £160 billion. As such it represents a significant element of the personal wealth and security of many individuals. It follows that the way in which these organisations are run is important to the overall health of the economy as well as to the financial well being of the individual policyholders concerned.

2.2 The mutual is a particular way of organising an economic enterprise. Unlike the more prevalent form of the company limited by share capital, mutuals have no external shareholders. Instead, in the case of financial mutuals, their risk capital is supplied by customers. Because of this, financial mutuals avoid the potential for conflict between the interests of customers and shareholders, and the potential for inefficiency to arise as a result. However, as with proprietary companies, a potential for conflict remains between owners and managers, which, in the event of poor accountability, can give rise to inefficiency. Mutuals confer on some or all of their customers certain membership rights, which tend to include rights to vote at annual general meetings, to receive information and to oversee certain aspects of the firm, including the appointment of directors and auditors. As such their role is similar to but not the same as the role of shareholders in a proprietary company.

2.3 Historically, financial mutuals in the UK have been grouped around the provision of long-term financial services such as mortgages and life insurance. Their prevalence in these areas has been due to some of the apparent advantages of the mutual form in these contexts, notably its customer focus (because there are no shareholders). It is widely held that financial mutuals also enjoy a low cost of capital by virtue of not needing to remunerate external suppliers of risk capital, which can have a positive impact on the return they are able to deliver to customers. Whether or not this potential benefit is actually delivered to customers will depend on how well the firm is run.

The role of corporate governance

2.4 The term corporate governance refers to the structures and processes by which firms are controlled. Good governance has an important role to play in the efficient running of firms in general, be they proprietary or mutual. In a well-functioning organisation the owners (shareholders or members) of an enterprise play a role in maximising its performance by seeing that high quality boards of directors are appointed. In their turn, these directors incentivise and monitor the performance of managers. The owners hold the firm accountable for its performance, informed by an adequate and transparent flow of information. Good corporate governance is about making all these relationships work.

2.5 In his report into events at Equitable Life – a mutual insurer – Lord Penrose made a number of observations about corporate governance practice. In particular that accountability was poor because:

- There was ineffective scrutiny and challenge of the executive of Equitable due in part to the non-executive directors having insufficient knowledge and skills, and failure by the board to put in place appropriate mechanisms to see that it had the information and advice to exercise its responsibilities;

- The board itself was not subject to effective external discipline or scrutiny. In Equitable the ownership voice was relatively weak, due to its highly dispersed ownership, and the relative difficulty members faced in forming coalitions.

2.6 As a consequence, in Lord Penrose's view:

"...the Board was a self-perpetuating oligarchy amenable to policyholder pressure only at its discretion."

Corporate governance issues for life mutuals

2.7 In accordance with its terms of reference, the starting point for this Review was to consider the governance framework for mutual life offices and to compare and contrast it with the framework in place for comparable proprietary companies. The Review has looked at this both empirically and from a theoretical perspective.

2.8 The theoretical work suggests life mutuals face a number of specific corporate governance issues.

A "gap" 2.9 The first is what might be described as a "gap" in the formal rules to which life mutuals are subject. Proprietary companies in general are subject to a number of formal corporate governance requirements given force through the Companies Acts and associated legislation. In addition, listed companies face some further requirements, mainly, but not exclusively, through the Listing Rules¹. Life mutuals are not subject to the same requirements. Of particular relevance to this Review is:

- The absence for life mutuals of binding corporate governance guidance. Listed companies are required under the Listing Rules to make a statement on their compliance with the Combined Code. Mutual life offices are not subject to any such obligation but many choose to adhere to it voluntarily;
- The relative paucity of information disclosure by life mutuals. Of particular relevance are requirements to disclose directors' remuneration, Department of Trade and Industry (DTI) proposals for listed companies to prepare an Operating and Financial Review (OFR), and requirements to disclose, and in some cases vote on, certain large transactions, none of which apply to life mutuals;
- Unlike their proprietary counterparts, life mutuals are not subject to uniform obligations governing their relationships with their members. The Companies Acts contain detailed rules governing the convening and conduct of Annual General Meetings (AGMs). The Listing Rules indicate further subjects on which they must consult members. There is no single set of rules or guidance for life mutuals whose own conduct of this key relationship is governed by a number of different statutes (which are generally less prescriptive in this area than the Companies Acts) and by firms' own, distinctive, Rules or Articles of Association.

¹ See http://www.fsa.gov.uk/pubs/ukla/lr_chapters4

External monitors 2.10 The Review examined whether this difference is warranted by the particular nature and structure of mutual life offices. The Review considered in particular the arrangements that exist for external scrutiny of mutual life offices and the wider market disciplines that they face. In doing so the Review is particularly grateful for Professor David Llewellyn's input to its work. A paper he prepared for the Review is to be found on the Review's website². The Review's main findings were that:

- The mutual form of ownership has a number of characteristics that go some way in explaining why it has been the traditional home of life insurance. In particular as mutuals do not need to have a separate supplier of capital independently of customers they avoid the potential and unnecessary conflict between the interests of customers and shareholders;
- However, members' voice is relatively weak in life mutuals compared to that of shareholders, particularly large shareholders, in a proprietary company. Members' voting rights are typically not in proportion to the size of investment. As a consequence 'ownership' is widely dispersed, with no individual or group able to build up a controlling position. They also lack the information, the resource and the motivation to actively monitor the firm;
- Members 'voting with their feet' can mitigate this in some types of mutual. In particular, in building societies, members can show their disapproval of management by taking their business elsewhere. This option of exiting the relationship is effectively not available to many life mutual members;
- Because they have no tradable equity, there is no effective market for corporate control of life mutuals which, unlike proprietary companies, are less vulnerable or responsive to the disciplines of the threat of hostile takeover or movements in the share price;
- The relative weakness of members' voice and absence of equity market disciplines are not compensated for by the strength of other external monitors. In most other respects the external environment for life mutuals and their proprietary counterparts is the same. They compete in the same product markets and are supervised on an equal basis by the FSA. Market monitors, such as Independent Financial Advisers (IFAs) and rating agencies, look at mutuals and proprietary companies in much the same way. A key difference between the mutual and proprietary sectors in this context is size. Proprietary life companies tend to be large. Life mutuals vary in size and many are very small. External scrutiny of these smaller firms is weaker than it is of their larger counterparts because the principal agents tend to concentrate their monitoring activities on larger firms.

² "Issues in the governance of mutuals in the financial sector", David T Llewellyn, December 2004, www.hm-treasury.gov.uk/myners

Complexity 2.11 The other important factor is the complexity of the life insurance business. In a mutual this has a number of implications for the way that corporate governance operates. In particular:

- The nature of the business, particularly its complexity can inhibit effective monitoring by members, other external monitors and by non-executive directors;
- Defining success in a life mutual is a more complex issue than it is in a proprietary company where the primary business objective – maximising shareholder value – is conceptually relatively straightforward.

2.12 As a consequence of these issues, scope for inefficiency arises in certain circumstances due in particular to poor accountability.

Consultation and research

2.13 This analysis has been complemented by a number of additional pieces of commissioned research³ as well as the consultation process undertaken by the Review⁴.

Corporate governance guidance 2.14 One of the main points to emerge from the consultation is a consensus in favour of binding corporate governance guidance for life mutuals based on the Combined Code. Many life mutuals currently adhere to the Code on a voluntary basis, and not surprisingly in the light of this, a quantitative survey of corporate governance practice revealed no strong evidence that mutual life offices as a whole are significantly less compliant with best practice than their proprietary counterparts.

2.15 Within that, in some respects mutuals adhere more closely to the Code than proprietary life offices but in others mutuals lag behind their proprietary counterparts. What is clear from an analysis of these areas of relative strength and weakness is that:

- Mutuals' relative strengths relate in large measure to their history and traditions. For example, they tend to have more non-executives on their boards than their proprietary counterparts, reflecting the historic legacy of mutuals which in the past have tended to have non-executive supervisory boards (that in some cases were affinity based) overseeing an executive management board.
- An important area of relative weaknesses is in public disclosure of information. This is not surprising as many proprietary insurers are compelled to publish a certain amount of information, for example on their compliance with the Combined Code and on directors' remuneration, but equivalent life mutuals are not;
- Another important difference is in the way that mutuals relate to their members. While many have good arrangements for convening and running AGMs, fewer mutuals tend in practice to have fair and open voting processes. Again this is not surprising as proprietary companies are all subject to uniform rules that prescribe minimum standards.

³ Two research studies are published on the Review's website, www.hm-treasury.gov.uk

⁴ "Myners review of the governance of life mutuals: consultation document.", July 2004

2.16 It is also clear from the survey that while some mutual life offices adhere to high corporate governance standards, some in the industry do not. There are also some parts of the Code for which the level of adherence in small life mutuals in particular is low, though this may be more of a reflection of their size than of their corporate form.

Member relations **2.17** The consultation asked for suggestions for how life mutuals can foster a better dialogue with members. The overwhelming majority of those who expressed an opinion favoured member panels. Some also suggested that non-executive directors should play a greater role in representing consumer interests and communicating with members. All those who commented on the matter favoured the idea that guidance might be provided on best practice information disclosure to members and on member voting procedures.

2.18 Research into members' attitudes revealed a high level of awareness of the fact that they are mutual members and of the key characteristics of mutuals (notably the absence of shareholders) as well as a very positive attitude to mutuality and a high degree of trust in their mutual. Most members, especially members of affinity-based mutuals, prefer to be relatively inactive and uninvolved in the firm though a significant minority (a third) prefer to be very or fairly active and involved. The majority feel their firms are accountable to them as members and feel that this is demonstrated by the provision of information and by the firm being responsive to members. Most (75 per cent) members are satisfied with the amount, quality and timeliness of information they receive, but those "activist" individuals who wish to be more involved tend also to favour more information disclosure.

2.19 This confirms the importance of information as a tool for securing accountability to members. But in providing information the emphasis should be on its quality rather than quantity for the majority of members. There nonetheless exist a sizeable minority of members who are amenable to playing an active role in their firms' corporate governance, and who should be engaged. Dialogue with these members might be enhanced through making available additional information.

Role of non-executive directors **2.20** In addition to asking a number of questions in the Review's consultation document about the role of non-executive directors, the team also undertook a series of interviews with chairmen and non-executive directors of the largest life mutuals to understand more fully their individual perspectives on the non-executive role and the challenges they face. The key issues to emerge from these interviews and responses to the consultation exercise were:

- The quality of information provided to non-executives has been an issue in the past, though it is now improving, largely due to external impetus (especially from the FSA). Nonetheless, some non-executives miss the input provided by external monitors of proprietary insurers (such as securities analysts, rating agencies and other commentators) which tends only to exist for the very largest life mutuals;
- In addition to adherence to the Combined Code, the governance of life mutuals is likely to be further strengthened by careful attention to the need for clear definition of corporate purpose, supported by well-defined principles of delegation from the board to management that are supported by strong monitoring and reporting processes;

- A related difficulty is defining performance measures that are clearly linked to the success of the business. An underlying challenge is in defining clearly what success means in the mutual context. This has the effect of complicating the monitoring task. Research commissioned by the Review⁵ suggests that in practice there is no consensus on performance measurement among life mutuals, which deploy a large number of different measures. It is important that non-executive directors should have a clear appreciation of what it is that they are measuring, so that they can gain a proper understanding of their businesses' performance;
- Boards vary in their approach to board construction. Some aim for a well-balanced mix of professional skills (typically actuarial, legal, accounting and investment management) among their non-executives. Others have focussed on recruiting individuals with broader general management and corporate finance experience. Some affinity based firms reserve places on their board for member representatives;
- On any model, the calibre and suitability of the individual is important as well as the overall mix of the board. Each board member must be able and willing to engage in sufficient questioning to ensure a proper understanding of the issues, and to feel free to challenge the executive as appropriate;
- Complexity can be dealt with through a combination of better skills on the board and access to specialist expertise. Clear delegation between the board and the executive is also important, based on a clear delineation between management and corporate governance. Independent advice has a potentially important role to play in empowering non-executives to gain a full understanding of the issues at stake. Non-executives generally recognise the value of ongoing relevant training.

Preliminary policy conclusions

2.21 Drawing on this analysis, and bearing in mind the Review's remit to "*bring forward recommendations to ensure that boards of mutual life offices are as accountable to their members as boards of comparable companies are to their shareholders*", the Review reached a number of initial policy conclusions. These were that in the mutual life sector:

- To achieve accountability of management to the board, the principles of independence, transparency and separation of function should be established;
- Consistent good corporate governance standards should be promulgated through appropriate guidance;
- The internal monitoring role of non-executive directors assumes greater importance and needs to be able to deal with the complexity of the business;
- Accountability to external monitors, particularly members, should be strengthened.

⁵ A survey of life mutuals' performance measurement by Cazalet Consulting

2.22 The rest of the Review's work has sought to establish how best to promote these outcomes, consistent with its remit. In outline, the Review's conclusion is that the most appropriate means of delivery are:

- Corporate governance guidance that is established as a clear industry standard and adopted throughout the sector. The guidance should reflect the unique circumstances of the sector, and in particular to define the role of non-executives better and to help equip them to deal with complexity. At the same time it needs to be flexible to accommodate the many different types of life mutual;
- Disclosure of good quality information to market monitors and to members;
- Best practice guidance on firms' relations with their members.

CORPORATE GOVERNANCE GUIDANCE

2.23 The Combined Code on Corporate Governance, published by the Financial Reporting Council (FRC), contains a set of principles of corporate governance in the UK. It has been developed primarily in the context of listed companies – indeed the Code is annexed to the Listing Rules to which such firms are subject. The Code is not mandatory for other firms but is broadly accepted as a benchmark for other forms of undertaking. It deals with a number of generic corporate governance issues including: the respective duties of the board and management; the selection, structure and operation of the board; the execution of duties reserved to the board as well as relations with shareholders.

2.24 Although the Combined Code is directed at the circumstances of listed companies, in practice, as Sir Derek Higgs put it:

“Much of the Combined Code addresses practical behavioural issues stemming from the important principles of separation of function, independence and transparency. As such, a significant proportion of it is of relevance more widely than just to the listed company sector, including to mutual life offices.”

The overwhelming majority of other respondents to the Review's consultation agreed with this view. Indeed many life mutuals already seek to adhere to the Code. In the light of this, the recommendations in this report are based on the principles set out in the Code.

2.25 At the same time, it is clear that the Code is not in all respects entirely appropriate for life mutuals, which, as noted earlier, differ in several important regards from listed companies. In view of this, and supported by the majority of respondents to the Review's consultation, the Review has taken the approach of annotating the Code to offer guidance on its application in the life mutual context.

2.26 Specifically, the Review recommends that life mutuals should adhere to a version of the Combined Code that is annotated with guidance that does not alter the principles of the Code but aims rather to promote interpretations that best uphold these principles in this sector. A draft is to be found at Annex D. The advantage of this approach is that it very clearly grounds the guidance that applies to mutuals in the Combined Code. By doing this the Review hopes to emphasise that mutuals are adhering to best practice as defined in that Code. The alternative approach of adapting the Code would run the risk that it might be perceived to be an alternative or even inferior standard. The Review also expects that this approach will minimise the risk that in time the mutuals version of the Code and the Combined Code will diverge.

2.27 The Review calls upon the AMI and the AFS to consult with their members on the draft annotations with a view to agreeing a final version for adoption at the beginning of the financial year 2005-06. Thereafter the Review expects the AMI and the AFS to collect and publish annually information on adherence to key aspects of the Code. It is recommended, furthermore, that the Treasury conducts a review of compliance by life mutuals with the annotated Code in early 2008, following the publication of annual reports for the financial year 2006-07.

2.28 The Review also notes that the FRC is intending periodically to review⁶ the Combined Code. The Review therefore recommends that the annotations to the Code for life mutuals are updated after each such review to ensure that they remain in step with changes in corporate governance best practice.

‘Comply or explain’ in the mutual context

2.29 Adherence to the Combined Code on a ‘comply or explain’ basis is required for listed companies under the Listing Rules. This means that companies must report on how they have complied with the Code and explain any departures from it. In practice it gives companies wide discretion not to adhere strictly to the detailed provisions of the Code provided their shareholders are content with the explanations offered.

2.30 Many life mutuals currently seek to adhere to the Code, but their action is voluntary. The Review has given considerable thought to the extent to which it should be compulsory, and if so how that might be achieved. In doing this, the Review’s objective has been to promote adherence to the Code while retaining the valuable flexibility of ‘comply or explain’. An important consideration is the relevance of the ‘comply or explain’ principle to the mutual context, in particular the presumption in the principle of an ongoing dialogue between the firm and its shareholders. For mutuals, particularly those that are not affinity based, there are some difficulties inherent in conducting a dialogue with a large and diffuse set of members. With these considerations in mind, the Review has concluded that life mutuals should adhere to the Code on a ‘comply or explain’ basis. Ultimately it will be for members to satisfy themselves that they are content with each firm’s arrangements. The Review has made a number of recommendations, covered later on, that will facilitate this process.

2.31 Respondents to the Review’s consultation were, on the whole, in favour of the FSA playing a role in promoting adherence to the Code. The Review agrees. The FSA is uniquely placed to do this, due to its ongoing supervision of the life insurance sector, and, as has become clear from the consultation process, the FSA is increasingly playing a pro-active role in taking corporate governance into account as part of its risk assessment process. Indeed, as is explored in Chapter 7, the increasing quality of engagement by FSA has led to better opportunities to form its own views on the competency and adequacy of management. With this in mind the Review is pleased to note that the FSA is carrying out work to ensure a consistent approach to its assessment of governance across all firms. It is particularly important, in this context, that the regulator should monitor the overall effectiveness of boards, rather than just the suitability of individual directors, and seek contact with non-executive directors as a regular part of its interaction with supervised firms.

⁶ See <http://www.frc.org.uk/press/pub0583.html>

2.32 It is important, however, to recognise that the FSA's actions are limited by its statutory powers. It must act in accordance with its statutory objectives. Good corporate governance plays an important role in delivering those objectives, but is not an objective of itself. Neither would it be appropriate for the FSA to effectively step into the shoes of members. Members are uniquely placed to exercise an ownership role and accordingly retain an obligation to secure their own best interests. They are a vital part of the corporate governance chain if the 'comply or explain' principle – and its valuable flexibilities – is to be applied.

2.33 The FSA clearly has an interest, though, in seeing that life mutuals adhere to the annotated Code. The FSA has, therefore, been consulted about its development and has welcomed this initiative. The FSA awaits the outcome of the consultation by the AMI and the AFS with their members on the draft. However, it has said it shares the Review's objective that, by following such guidance in the annotations, firms should be able to demonstrate that they have had regard to FSA's own high-level guidance relating to corporate governance. This should leave firms in no doubt as to the value of adhering to the annotated Code.

2.34 The Review believes that there are wider issues for the FSA to consider here and would like the FSA to carry out work to look in the round at the extent to which the Code is adopted across the sector. In particular, it will be important for the FSA to understand firms' reasons for not adopting the annotated Code as a model for governance, or for choosing to explain rather than comply with a particular provision of the Code, in order to understand whether there are any generic regulatory issues that may need to be addressed. The Review is pleased to note that the FSA has agreed to look at these issues in 2008, by which time the Code should be well established in the sector.

Small firms

2.35 Just as the Combined Code applies to all listed companies, the Review envisages that the annotated Code will be relevant to all mutual life offices, including small friendly societies. While small firms will tend to operate under greater cost constraints than larger firms, the governance principles enshrined in the Code such as independence, transparency and separation of function are applicable to all. The flexibility inherent in 'comply or explain' should permit smaller firms to adhere to the principles in a manner that is appropriate to their circumstances. The Review appreciates however that the very smallest firms (particularly the so called "non-Directive"⁷ firms) may need some further guidance on interpreting the provisions of the Code. In view of this the Review has invited the AFS to consider what further guidance might be appropriate for these firms. Small firms will also be included in the work to be carried out by the FSA described in the previous paragraph.

⁷ See footnote to paragraph 4.8

Annotations to the Code

2.36 As noted above, the Review has drafted a number of annotations to the Combined Code. A full version of the Code with draft annotations is to be found at Annex D. In summary, the annotations offer the following pieces of guidance:

1. The 'comply or explain' principle is relevant to life mutuals. To give this effect each firm should make a governance statement in its annual report;
2. The role played by the FSA in securing adherence to the Code (as outlined above);
3. Firms should publish a directors' remuneration report and put it to an advisory vote by members;
4. In a life mutual it is particularly important:
 - That there are more rather than fewer independent directors;
 - That non-executive directors should meet without the executive present;
 - That a formal and rigorous appraisal of the board takes place each year;
 - To promote external input to the board nominations process. To complement this the annual report should contain a description of each director's expertise and experience and a statement about board balance, completeness and appropriateness to the requirements of the business;
 - For non-executive directors to receive appropriate information and proactive support. In Chapter 9, this report recommends a number of ways in which this might be achieved, and draws attention to the importance of the company secretary in this regard;
 - For non-executive directors to receive appropriate induction and ongoing development training. In support of this the Review recommends that the AMI and the AFS work in consultation with the FSA, the Institute of Directors (IoD) and the Institute of Chartered Secretaries and Administrators (ICSA) to develop an induction and professional development programme.
5. Boards should consider how dialogue with members can best be conducted. They should articulate their policies on member relations to their members;
6. Management incentive schemes should use performance criteria that reflect the best interests of members.

ACCOUNTABILITY

2.37 As noted in paragraph 2.9 above, most proprietary insurers are (or shortly will be) obliged under company law and the Listing Rules to make a number of information disclosures. Life mutuals are not subject to the same requirements, though some do choose to publish the information voluntarily.

Information disclosure 2.38 The Review regards it as fundamental to achieving proper accountability by life mutuals that, in addition to the steps already set out, they should make public some of the key pieces of information that are published by equivalent proprietary companies. The Review accordingly recommends that in future, in addition to publishing a report on directors' remuneration, all large⁸ life mutuals should also publish information on performance and strategy, in the form of an OFR.

2.39 The Review does not consider, on current evidence, that it would be proportionate to legislate to require firms to publish this information. This judgement rests to a large degree on the belief that the industry is itself willing to take the necessary action to deliver better practice in this respect. To that end the Review expects the AMI and the AFS to monitor and publish information on the progress made by their memberships.

2.40 The FSA has in recent years taken a number of welcome steps to bring greater transparency to the life sector. In addition to introducing realistic accounting and the publication of Principles and Practices of Financial Management (PPFMs), proposals (in the FSA's CP202⁹) to require firms to make available information on life policy payouts on surrender and maturity are particularly welcome. The Review hopes that the FSA will continue to build on this, in particular by considering what further information might be developed to give the members of life mutuals an impartial and informed perspective on policy performance and the sustainability of that performance.

Involving members 2.41 The Review's analysis and consultation responses serve to underline the vital importance of life mutuals engaging their members:

- Members are uniquely placed to represent the 'ownership' interest in the firm. While other agents may perform monitoring roles, none of them can substitute entirely for this interest;
- The long-term nature of many life products and the long-term nature of the provider-customer relationship (not least because exit can be prohibitively expensive) make governance a central part of the transaction;
- Ongoing dialogue with a firm's owners is a fundamental part of good corporate governance. Boards should recognise this responsibility and take the necessary action to engage with their members, even if that is not easy.

2.42 In many respects these issues echo those considered in relation to pension funds in the Review of Institutional Investment in the UK¹⁰.

2.43 To ensure that all members of life mutual offices have a reasonable opportunity to exercise their membership rights, the Review recommends the AMI and the AFS work together to devise and to promulgate guidance for their members that promotes best practice in this respect. This should include two main elements:

- Guidance on how to operate fair and accessible voting arrangements. While all life mutuals confer on members the right to vote, the ability of members to exercise that right is often restricted. The Review has set out some guiding principles that the guidance should draw upon;

⁸ Firms with more than £500 million of long term insurance assets.

⁹ "Insurance regulatory reporting: changes to the publicly available annual return from insurers", September 2003.

¹⁰ "Institutional Investment in the United Kingdom, A Review", Paul Myners, 2001

- Guidance recommending the establishment of a member relations function, responsible for a member relations strategy, including:
 - Promoting dialogue with members;
 - Provision of information to members;
 - Facilitating discussion among members.

2.44 Information to members should include notification to members of major transactions by the firm. It is a recognised principle among listed companies, building societies and co-operatives that shareholders or members should be notified and have a say in major transactions as these may have a bearing on their fundamental interests. The Review does not regard life mutuals as any different in this respect.

2.45 These arrangements are supported by an annotation of the Combined Code that clarifies the responsibilities of the Board as a whole to conduct a dialogue with members.

2.46 The Review also urges members to engage wherever possible, as their input is unique and important. However the Review recognises the limitations on what can be expected of individual members (who are not well resourced and may not be motivated to act). The recommendations in this report should, therefore, be seen as a package of complementary measures that together aim to address the governance and accountability issues it has identified.

2.47 The Listing Rules require the external auditor to review the company's statement with regard to those sections of the Code relating to Accountability and Audit. The Review recommends that this should be regarded as best practice by life mutuals.

MUTUALITY IN THE FUTURE

2.48 Financial mutuals in the UK have traditionally been grouped around long term capital services such as mortgages and life insurance, where:

- There is a widely held view that they enjoy a low cost of capital by virtue of not needing to remunerate external suppliers of capital (in the form of a required rate of return on equity);
- There are potential efficiencies to be gained from a long-term investment strategy that is not unduly influenced by the short term demands of shareholders. (Though as noted in paragraph 2.10, this needs to be balanced against the potential for inefficiency as a consequence of weak accountability);
- It is held that customers place a high value on stability.

2.49 There are also wider public policy interests in a mixed system – with both proprietary and mutual firms – because of the implications this has for providing a diversified structure and increased competition, with the consequences that has for financial stability.

2.50 Questions have been asked in the Review about de-mutualisation, and about what role corporate governance checks and balances have played in these and other major strategic decisions. The mutual life insurance sector has seen 12 firms de-mutualise during the last 11 years (a list is at Annex C) during which time its market share has shrunk from a high of over 50 per cent¹¹ (in 1995) to 16 per cent in 2003¹². The largest life mutual (Standard Life), has recently signalled its intention to recommend de-mutualisation to its members.

2.51 A number of the people the Review has consulted have made the point that in some cases short-term self-interest has had a significant role to play in decisions to de-mutualise. It is clear to the Review that while this may have been the case, there nonetheless can exist good reasons to de-mutualise in the best interests of members and policyholders more generally.

2.52 What is important is that all major strategic decisions are taken in the best long-term interests of members. It is also important that members are properly informed of such decisions and the implications those decisions may have for their future interests. The measures outlined above to improve accountability and dialogue with members should help ensure this is the case.

2.53 In addition, the Review considers that as a matter of best practice, in the event of any future motions to de-mutualise, the structure of the motion should pay heed to the potential for conflicts of interest to arise, in particular over the remuneration of directors. Accordingly the Review recommends that, as required under the Building Societies Act 1986, any question of an increase in directors' remuneration or compensation to directors should be the subject of a separate motion to any motion to de-mutualise.

CONCLUSION

Taking forward the Review's conclusions

2.54 Good governance provides the checks and balances that ensure that firms are run efficiently and meet the objectives of their owners, be they shareholders in a proprietary firm or members of a mutual. It is apparent that life mutuals face a number of specific corporate governance issues as a result of their particular form of ownership and the nature of the business they conduct. This report aims to address these issues and contains a range of recommendations that aim to provide the basis for life mutuals to ensure that their governance will compare very favourably to best practice in proprietary firms. But the success of any review of this type should be judged not from its recommendations but from the extent to which it promotes enduring change.

2.55 The mutual insurance sector has already done much to address the issues raised by Lord Penrose in his Report on Equitable Life, and has shown a clear commitment to the principles of good governance. Governance is already good in a number of life mutuals – but clearly also less good in others.

2.56 What has also become apparent is the strong group identity of the life mutual sector – the realisation that just as problems for any one firm could tarnish the whole group, the collective interest lies in protecting and improving the mutual brand. And good governance should be part and parcel of mutuals playing to their strengths; accountability and transparency are very much in the spirit of the mutual form – but in mutuals, as elsewhere, they require effort and vigilance if they are to be sustained.

¹¹ "Mutual life offices: a contribution to the governance debate", O'Brien, Diacon, Drake and O'Sullivan, 2004.

¹² Data provided by the Centre for Risk and Insurance Studies at the Nottingham University Business School.

2.57 It is, therefore, to the sector itself that falls a large part of the task of ensuring that there is continuing improvement in the governance of mutual life offices. The Review looks to the AMI, working with the AFS, to consult with their members on the draft annotated Combined Code for life mutuals with a view to agreeing a final version for adoption by financial year 2005-06. To them also falls the task of updating the annotated Code in the future, in step with reviews of the main Code, and the publication of annual statistics on the adoption of key elements of best practice. To make this work, each and every firm will have to decide what steps it needs to take. The Review calls on the chairman of each mutual life office to set matters in motion in his or her own firm.

2.58 The Review also calls on the AMI and the AFS to develop best-practice guidance on fair and accessible voting arrangements and member relations, drawing on the principles set out in this report.

2.59 To assist chairmen and the trade bodies in ensuring these issues continue to receive the attention they deserve, the Review asks the Treasury to review progress with regard to the Review's recommendations early in 2008. If progress is not seen, the Review urges the Treasury then to consider whether more prescriptive action is called for.

2.60 The Review also welcomes the continuing improvements that the FSA is making to the regulatory environment for mutual life offices. The Review urges the FSA to build on current efforts to secure good governance as an essential step towards ensuring that firms are run in the appropriate manner. This report has set out several ways in which we believe they may do this.

2.61 The Review is pleased that the FSA shares our objective that, by following such guidance in the annotations, firms should be able to demonstrate that they have had regard to FSA's own high-level guidance relating to corporate governance. This is important for ensuring that the annotated Code is adopted throughout the sector, a fact that needs to be borne in mind during the consultation on the draft annotated Code mentioned in paragraph 2.57.

2.62 To the FSA also falls the specific task, in 2008, of carrying out work to look in the round at the extent to which the Code is adopted across the sector. In particular, it will be important for the FSA to understand firms' reasons for not adopting the annotated Code as a model for governance, or for choosing to explain rather than comply with a particular provision of the Code, in order to understand whether there are any generic regulatory issues that may need to be addressed.

Lessons for other mutuals

2.63 The terms of reference directed the Review to consider, where appropriate, general principles for other types of mutual. Throughout the Review we have compared and contrasted the situation in the mutual life sector – the theoretical governance issues, the legislation and the current best practice – with that in other forms of mutual, particularly financial mutuals, and most obviously building societies.

2.64 The building society sector has at times faced criticism on governance but has developed a good record on working together to promote best practice in governance and other areas, for which the Building Societies Association (BSA) can take considerable credit. The BSA published earlier this year its own annotated version of the Combined Code for its members and publishes statistics on a number of governance issues. We hope and expect the good work to continue. We also applaud the efforts by

Co-Operatives^{UK13} to update its own governance code and to drive the adoption of best practice in that sector.

2.65 While the principles of good governance that we have sought to apply during the Review remain universal, the recommendations relate specifically to life mutuals. This is largely a reflection of the progress already made in other sectors and discussed above. But the close focus on life mutuals relates also to the specific characteristics of life business that make good governance especially important.

2.66 That said, the issues raised in this report and the recommendations of the Review will be of interest and direct relevance to other forms of mutual. We suggest that all such firms review their current governance arrangements in the light of the principles and practices discussed in this report.

LIST OF RECOMMENDATIONS

Recommendation 1: To mitigate the risk of conflicts of interest arising, any question of an increase in directors' remuneration or compensation to directors in the context of a motion to de-mutualise should be put to members as a separate motion as required under the Building Societies Act 1986.

Recommendation 2: Given the importance of the role of non-executive directors in life mutuals, meetings between FSA supervisors and non-executive directors of life mutuals (without the executive present) are a valuable part of the interaction between the FSA and supervised firms.

Recommendation 3: Life mutuals should adhere to a version of the Combined Code that has been annotated with guidance that does not alter the principles of the Code but aims rather to promote interpretations that best uphold these principles in this sector.

The AMI and the AFS should consult with their members on the draft annotations in Annex D with a view to agreeing a final version for adoption for the beginning of the financial year 2005-06.

The AMI and the AFS should collect and publish annually information on adherence to key aspects of the Code.

The Treasury should conduct a review of compliance by life mutuals with the annotated Code early in 2008, following the publication of annual reports for the financial year 2006-07.

Recommendation 4: The AMI and the AFS should ensure that the annotations to the Code for life mutuals are updated when the Combined Code itself has been reviewed.

Recommendation 5: Life mutuals should adhere to the annotated Code on a 'comply or explain' basis. A governance statement in the Annual Report of the form described in 12.43A of the Listing Rules should be seen by all firms as an essential part of this process.

It may be appropriate to discuss governance arrangements directly with member representatives. Firms should also anticipate that the FSA would wish to discuss compliance and their explanations for departures from the provisions of the Code in the context of a risk assessment or other supervisory work.

¹³ The first draft of the new Co-operatives^{UK} Corporate Governance Code of Best Practice for Consumer Co-operatives is currently out for consultation. The consultation closes on 31 January 2005.

In taking forward the consultation on the annotated Code, the AMI and the AFS should be mindful of the objective, shared by the Review and the FSA, that by following such guidance in the annotations, firms should be able to demonstrate that they have had regard to FSA's own high-level guidance relating to corporate governance.

The FSA is to take forward, in 2008, work to understand firms' reasons for not adopting the annotated Code as a model for governance, or for choosing to explain rather than comply with a particular provision of the Code, in order to understand whether there are any generic regulatory issues that may need to be addressed.

Recommendation 6: Life mutuals should require the external auditor to review the company's statement with regard to Code provisions C1.1, C.2.1, C3.1, C3.2, C3.3, C3.4, C3.5, C3.6 as described in listing rule 12.43A Requirements of the auditor.

Recommendation 7: The AFS, working with the AMI, should produce more detailed guidance on the interpretation and application of the annotated Combined Code for small friendly societies.

The FSA should pay due attention to small firms when it undertakes the work described in recommendation 5.

Recommendation 8: The annual report of a life mutual should contain a description of each director's expertise and experience. Alongside this in the annual report, the board should make a clear statement about its own balance, completeness and appropriateness to the requirements of the business. Both statements should also be available on the firm's website.

Recommendation 9: The AMI and the AFS, in consultation with the FSA, the IoD and the ICSA should develop an induction and professional development programme for non-executive directors of life mutuals.

Recommendation 10: Appointments to the board should involve appropriate sources of objective external opinion, which may include considering using external recruitment consultants and seeking the views of member panels.

Recommendation 11: A rigorous board appraisal should be conducted annually in all life mutuals. This should cover not only the performance of individual directors but also that of the board as a whole.

Recommendation 12: The chairman and the company secretary should ensure that issues non-executives wish to be discussed are placed on the agenda.

Non-executives should receive the information and pro-active support that they require so that an informed discussion can take place.

When difficult issues arise, the first course of action should always be to encourage further and deeper analysis to be carried out within the firm but boards should establish clear procedures through which non-executives can obtain advice from independent external advisers at the company's expense when they "*judge it necessary to discharge their responsibilities as directors*".

Recommendation 13: All life mutuals should produce a remuneration report along the lines of that described in Schedule 7A of the Directors' Remuneration Report Regulations 2002 and conduct an advisory vote on the report at the AGM (as per S241A).

In addition, the data collected and published annually by the AMI and the AFS and the review of life mutuals' compliance with the Code to be conducted by the Treasury early

in 2008 should both cover the directors' remuneration report and the holding of an advisory member vote.

Recommendation 14: Large life mutuals should produce an OFR in the same way as quoted companies will shortly be required to.

Recommendation 15: The AMI and the AFS should devise guidance that promotes best practice member relations. This should include guidance on fair and accessible voting arrangements as well as advocating the establishment of a member relations function, responsible for a member relations strategy. The guidance should cover promoting dialogue with members, provision of information to members and facilitating discussion among members.

Recommendation 16: All life mutuals should endeavour to put in place adequate arrangements for taking into account members' views. The AMI and the AFS should consider how best to promulgate information sharing on best practice among life mutuals. All firms should review their current arrangements (where these exist) and evaluate them in the light of the principles in box 13 (in Chapter 10). The AMI and the AFS should develop these principles as part of the guidance on member relations.

Recommendation 17: Life mutuals should adopt the practice of notifying members of major transactions. Members' consent should be sought in the case of very large transactions. The AMI and the AFS should devise best practice guidance on appropriate thresholds.

