



Myners review of the governance of life mutuals

Response of Royal London to the July 2004 consultation document

September 2004

17th September 2004

1. Introduction

This is the response of The Royal London Mutual Insurance Society Limited (“Royal London”) to the consultation document published on 9 July 2004 by the independent review of the corporate governance of mutual life offices being undertaken by Paul Myners. Royal London welcomes this opportunity to contribute to the debate on the governance of mutual insurance companies.

A draft of this document was considered by the Board of Royal London at a meeting on 25 August 2004. This response reflects the views of the Board.

In this response, we make by way of executive summary some general points that we would wish the review team to consider (section 2) and then address in detail the questions posed in the consultation document (section 3).

2. Executive Summary

1. Many mutual life insurers are consistently among the best performers:
 - 7 of the top 10 performers for ten year terms are mutuals
 - all but 2 of the top 10 performers for twenty five year terms are mutuals

With no shareholders, mutuals can focus on the interests of their members and other policyholders. Mutual life insurers exert an important competitive influence on the UK financial services industry. Any diminution of this influence risks the creation of a more inefficient market. Diversity of corporate structure is essential for a healthy and competitive financial services industry.

2. For mutual insurers to flourish, consumers must have confidence in this form of corporate structure. Consumer confidence in the mutual sector can be enhanced by a robust framework of corporate governance and greater visibility and accountability.
3. The issues identified by Lord Penrose as shortcomings in the governance of Equitable Life were, in our view, either not present in other mutual insurers or have largely been addressed by the companies themselves (many of which have long since voluntarily

accepted that the Combined Code applies to them) and by FSA regulation, in particular realistic reporting and PPFM.

4. Given this progress, we do not believe that any radical new options are required, at least in the major mutual insurers, who are already “accountable” to the market – IFAs, the financial press, independent commentators and rating agencies. This being the case, we question the need for an additional body that would exert an influence on a mutual similar to that exerted by institutional shareholders on a plc, even though the absence of such an influence at Equitable Life was much regretted by Lord Penrose.
5. That view is re-affirmed by the fact that there is no obvious mechanism for creating an influence akin to that of the institutional shareholder in a mutual insurer. We have considered a number of options:
 - it is unlikely that the FSA would be willing to assume this role and become involved in the management of mutual insurers
 - a two-tier board we regard as having no advantage over strong and independent non-executive directors – a supervisory board would create a body unknown to UK law, the role and status of which would be uncertain
 - a committee of members that the board agrees to consult on major matters is already in place in some cases although unless augmented by external professionals would probably lack the breadth of experience of institutional investors
 - the delegate system adopted by at least one major friendly society hardly seems a step forward in the light of current thinking, and would only be practical where an appropriate regional structure was in place anyway.
6. A radical approach worthy of consideration would be to permit mutual insurers to issue some form of capital that would be of interest to institutions thereby creating real, as opposed to substitute, institutional shareholders. This would have the additional advantage of creating a means by which mutual insurers would have access to capital.
7. A specific obligation, similar to that imposed on quoted companies by the listing rules, should be placed on mutual insurers to comply with the Combined Code or explain non-compliance.

8. Non-compliance with the Code should be given greater prominence. A format for the corporate governance report that mutual insurers would be required to include in their annual report and accounts should be prescribed. This report would also be published on the firm's website and sent annually to the FSA.
9. The corporate status (mutual or proprietary) of a life insurer should not impact on the structure of governance, and (for example) the role and expertise of the non-executive directors, the make-up of the board and the board committees that are put in place should be the same regardless of the status.
10. The FSA should include specialists on mutual insurers in their policy team (or there should be "pre-consultation" with representatives of mutual insurers) to ensure that the sector is not caught up in unintended consequences of proposed regulation.

3. Response to the questions

Q1. To what extent does the current guidance on corporate governance particularly the Combined Code provide an appropriate framework for mutual life offices? Would another approach be more effective?

The Code

We believe that The Combined Code on Corporate Governance (July 2003) ("the Code") provides a sound framework for the governance of both proprietary and mutual companies. We regard those aspects of the Code that are relevant to a mutual insurer as applying to Royal London and explain any non-compliance. Many other major mutual insurers (and building societies) adopt the same approach.

We do not believe that anything would be gained by producing an alternative code on corporate governance for mutual insurers. Quite the reverse, in fact - for the sake of consistency and consumer understanding of governance, plcs and mutual companies should comply with the same principles of corporate governance. We understand that the Council of the Building Societies Association has come to a similar view, and regards the Code as providing a suitable framework for the governance of building societies. It does not favour a code specifically designed for building societies.

Code guidance for mutual insurers

It would, however, be helpful if guidance could be provided in the areas in which the Code is unhelpful, and sometimes irrelevant, to mutual insurers. This would serve to achieve a consistent approach throughout the sector. The Council of the Building Societies Association is, we understand, developing similar guidance for building societies.

Simply substituting “member” for “shareholder” would be appropriate for much of the Code but not in sections D1 and D2 where this alone would not provide realistic guidance for a mutual insurer. Here additional guidance would need to be required because a mutual insurer is likely to have many members (far more than the number of shareholders in most quoted companies) none of whom have a major stake in the company and few of whom would want a dialogue remotely similar to that of a board of a quoted company with its major shareholders. There would need to be sufficient flexibility to accommodate the range of mutual insurers. There should not, for example, be a requirement to send the full version of the annual report and accounts to all members, although it should be posted on the website and available on request. A short form or other information pack (perhaps guidance could be given on the areas that should be covered) should be sufficient.

It might well also be helpful to:

- define a “smaller company” (A3.2, B2.1, C3.1 etc)
- include references to policyholders (and not just members) in for example A3.3 and Schedule A
- extend the references to “FTSE 100 company” to include a comparable non-quoted company (A4.4 & 5)
- delete the references to “major shareholders” (A5.1) and to “principal shareholders” (B2)
- delete the reference to share options in B1.1

Other approaches

We do not believe that any radical new options are required (at least in the major mutual insurers) over and above requiring compliance with the Code. This view is reinforced by the fact that there is no obvious means of creating an alternative to the institutional shareholder, the lack of which at Equitable Life was seen by Lord Penrose as a serious omission.

We have considered a number of alternatives. It is unlikely that the FSA would be willing to assume this role and become involved in the management of mutual insurers. A two-tier board we regard as having no advantage over strong and independent non-executive directors – a supervisory board would create a body unknown to UK law, the role and status of which would be uncertain. It might also cause something of a problem for directors' and officers' insurers. A committee of members that the board agrees to consult on major matters is already in place in some cases although its members, unless augmented by external professionals may lack the breadth of experience of institutional investors. The formal delegate system long since adopted by at least one major friendly society hardly seems a step forward in the light of current thinking – if anything it takes most of the members further away from management – while it would only be practical where an appropriate regional structure was already in place. It would also be difficult to replicate in the case of a mutual insurer incorporated under the Companies Act.

A radical approach worthy of consideration would be to permit mutual insurers to issue some form of capital that would be of interest to institutions thereby creating real, as opposed to substitute, institutional shareholders. This would have the additional advantage of creating a means by which mutual insurers would have access to capital.

We deal in our reply to Question 2 with the concept of “comply or explain” and in our reply to Question 11 with those “market forces” that we believe play a similar role to that of institutional shareholders, at least in the case of larger mutuals.

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

As we have said, we would like to see mutual insurers required to comply with the Code (or explain non-compliance) and the development of supplementary guidance to address those aspects of the Code that are not applicable to mutual insurers.

The obligation to “comply or explain” non-compliance with the Code should apply to the mutual sector. Currently listed companies are required to explain non-compliance in their report and accounts. This document does not perhaps carry the same prominence in mutual insurance companies as it does in quoted companies. It is by no means standard for every member of a mutual to receive a complete copy of the report and accounts, while a statement explaining areas of non-compliance may not, of itself, be of great assistance to the lay members, even if they do have access to it.

We would suggest prescribing a format for a corporate governance report for mutual insurers. A pro-forma of this report could be included in the supplemental guidance for mutuals in relation to the Code. An annual report in this form would:

- appear on the company's website
- be included in the report and accounts (with at least a summarised form being sent to members with the AGM mailing, where the report and accounts in full are not sent), and
- be sent to the FSA, thereby making them aware of the regulated firm's corporate governance performance during the year and enabling them to comment on it as part of their overall review, and during their dialogue with, the firm.

We believe that giving this role to the FSA is preferable to creating a new entity to review these reports. Such a task we would regard as part of the regulation of the firm.

The report – or at least those aspects of the statement that report on compliance, as opposed to explanations of non-compliance – should be audited by the company's auditors.

We note the observation in the commentary to Question 1 that the principle of comply and explain has been designed for plcs and “has as its foundation the existence of an on-going dialogue between the company and its shareholders.” We acknowledge that an aspect of the concept of “comply or explain” is that there will be, amongst those to whom the explanation is given, at least some who will respond and where appropriate challenge the explanations for non-compliance. We believe that this approach will create transparency and provide for that challenge – from members, from the regulator and from the analysts and others to whom we refer in our reply to Question 11, all of whom will have access to the corporate governance report.

Q3. In your opinion, should the ownership structure or the nature of the business conducted by a life mutual affect the composition or structure of its board? If so, how?

Two quite different concepts are run together by referring to “ownership structure” and “nature” in the same sentence. The nature of any business will inevitably affect the composition of the board.

Turning to the ownership structure, the issues facing the board of a mutual life insurer are the same as those facing a proprietary company. We are not

convinced that the corporate status of the company was a major contributor to the issues raised by Lord Penrose in connection with the performance of non-executive directors at Equitable Life, nor do we believe that these concerns were typical to the sector at that time.

A question sometimes posed is whether the role of a non-executive director is in some way different in the case of a mutual. We do not believe that it is, and this view is shared by our non-executive directors, all of whom have been – and in many cases still are – on the boards of listed companies. They see their role with Royal London as virtually identical (other than, of course, in the area shareholder relations) to the role of a non-executive director of a listed company.

So far as the balance of the board is concerned, we agree with the approach of the Code that states (para A.3.2) that at least half the board, excluding the chairman, should be independent non-executive directors.

We believe that it is appropriate for mutual insurers to have the same committee structure as that laid down in the Code with audit, remuneration and nomination committees. An insurer is also likely to have in place committees with responsibility for monitoring the capital of the company, and proposing action as required, and for appointing asset managers, setting investment benchmarks and monitoring investment performance. The latter committees may well not be limited to directors, but may include the appointed actuary and other senior executives.

We deal with the specialist knowledge of non-executive directors in our reply to Question 5.

Q4. In your experience, is the information and advice (including actuarial advice) used by the non-executive directors of life mutuals sufficient – in terms of quality and relevance – to enable them to exercise effective oversight of the executive? In what ways might it be improved? If more information and advice is needed, what are the resource implications? Do similar issues arise for the non-executives of other complex businesses, such as wholesale banking or science-based businesses?

We reply to this question in two parts. It is the intention of the executive of Royal London, and we would hope other insurance mutuals, to provide the non-executive directors with sufficient, relevant, quality information to enable them to discharge their responsibilities to the members. Non-executive directors are provided with regular briefings by the executive and there is ample opportunity to have open discussions between executive and non-executive directors at board meetings.

We have sought the views of our non-executive directors as to the quality and relevance of the information and advice that they receive. They responded as follows:

The capacity for effective oversight is substantially influenced by two factors. Firstly the quality of the advice received and the capacity of the individual non-executive to absorb it. The quality of actuarial and other advice given to the board at Royal London is high, and the capacity of the non-executive directors to absorb it is increased by the considerable lengths to which the executive go to inform (through seminars and well drafted and balanced papers) the Board as a whole. From time to time, the Board itself originates the request for this work to be done.

The Royal London non-executives who are not specialists in the field have sufficient information (and trust - see the second factor below) to make informed and detached judgements about the activities of the executive. To go further would run serious risks of not seeing the wood for the trees, and devoting too much time to certain issues at the expense of others that carry equally significant risks.

The second factor is the degree of trust and confidence that non-executives have in the executive. Recognising the need for change in the boardroom, it is nevertheless important that a proportion of the non-executives should have worked sufficiently closely with the executive for long enough to form well-founded views about their abilities and integrity.

In summary, it would be counter-productive for the non-executives to get so close to the issues that they are second-guessing the executive. Non-executives should be entitled to rely on the expertise available to them, provided they do so conscientiously and honestly, a point recognised by Lord Penrose.

Finally, and this is a point that does not just apply to actuarial issues, many other complex issues have to be addressed not only by the boards of insurers, but also many other businesses. To turn every non-executive (or executive for that matter) into an expert on every issue likely to confront the board is clearly impractical, as well as dangerous.

Q5. What is the role of the non-executive director in a complex or technical business? In particular what is their capacity to understand and to challenge the executive over technical aspects of the business?

The role of non-executive directors

We agree with the description of the roles of the non-executive directors contained in the Code (including Schedule B) and the related guidance and good practice suggestions from the Higgs report that were published with the Code. As we have said before, the role of a non-executive director of a life insurance company is essentially the same, regardless of the corporate structure of the company.

The guidance, having addressed the role of all directors, suggests that:

“...the role of the non-executive director has the following key elements:

- **Strategy:** *Non-executive directors should constructively challenge and help develop proposals on strategy.*
- **Performance:** *Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.*
- **Risk:** *Non-executive directors should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible.*
- **People:** *Non-executive directors are responsible for determining appropriate levels of remuneration of executive directors, and have a prime role in appointing, and where necessary removing, executive directors and in succession planning.*

“To be effective, non-executive directors need to be well-informed about the company and the external environment in which it operates, with a strong command of issues relevant to the business. A non-executive director should insist on a comprehensive, formal and tailored induction. An effective induction need not be restricted to the boardroom, so consideration should be given to visiting sites and meeting senior and middle management. Once in post, an effective non-executive director should seek continually to develop and refresh their knowledge and skills to ensure that their contribution to the board remains informed and relevant”.

This must be underpinned – in both mutual and proprietary companies – by:

- the nomination committee robustly undertaking its responsibilities in relation to the appointment of new directors
- a thorough and structured induction programme for all newly appointed non-executive directors along the lines of the induction checklist published with the

Code and on-going training and other action designed to keep knowledge up-to-date

- the documented right of the non-executive directors to seek advice from independent advisers at the company's expense
- a meaningful evaluation of the performance and effectiveness of the Board and its members.

The capacity of non-executive directors to understand

Relevant knowledge is, of course, important to a director of *any* company, regardless of its corporate structure and sector. Specialist knowledge amongst the non-executive directors will, however, always have to be coupled with independence, skills in the areas referred to above, a willingness to learn about the business as a whole, an ability to grasp complex concepts, skill in recognising and selecting highly competent executives, and a willingness to challenge the executive team.

Amongst directors of listed companies outside financial services are engineers, scientists, medical doctors and many others whose skills and qualifications are directly relevant to the business of that company. Other non-executive directors have clearly had considerable executive experience in companies in the same sector. On the other hand, we sense that specialists tend to be in the minority and that boards are largely comprised of people with immense general experience and possessing the skills to which we refer above. On this basis, it may well be appropriate for at least some of the non-executive directors of a life company (whether mutual or proprietary) to have an actuarial qualification or executive experience within a life company, or elsewhere in financial services. This is certainly the case on the current Royal London board.

Clearly it would be difficult to develop prescriptive rules as to the overall composition of boards, and indeed any attempt to do so would have to apply to proprietary companies. Directors, both executive and non-executive, already have to be approved by the FSA and Lord Penrose suggested that this process could be extended to cover the composition of the board. He wrote (Chapter 20, paragraph 23):

“Difficult though the exercise may be, there appears to be no alternative means of securing an independent view of the appropriateness of the membership of life offices’ boards than the exercise by FSA of powers to refuse approval on grounds that the nominee for appointment would not make a necessary contribution to the sound and prudent management of the office by filling a gap in the range of skills and experience required by the [life] office”.

We sense, however, that the FSA may well feel that they already have that power, in relation to both mutual and proprietary companies.

Q6. What can the owners of a complex or technical business reasonably expect of its non-executive directors? How would you characterise the practical limitations of a non-executive director? What steps might be taken to codify what is reasonable and realistic in this context? Should executives and non-executives have the same legal duties to the company?

There is little that we can add to our reply to the previous question. We agree with the description of the role of non-executive directors contained in the Code, while, as the question indicates, the law (both statute and common law) imposes duties on directors, both executive and non-executive.

In addition to these duties, the owners of a mutual life insurance company should expect the non-executive directors to ensure (as they are required to do) equity of treatment of the different categories of policyholder (both members and non-members).

As to the practical limitations, the strength of the non-executive directors could be said to include a potential weakness. They can provide an independence of view in terms of leadership, strategy and values, and challenge and monitoring. They can bring to bear experience from different companies, sectors and even industries as well as from the market. They can provide a valuable conduit for regulators on the basis that they are apart from the day-to-day management. On the other hand, their involvement in the company is of necessity limited – if it was otherwise, they would lose their independence.

The question on legal duties involves technical legal issues that possibly extend beyond corporate governance. We provisionally agree with the approach adopted in Schedule B to the Code. The duty should be expressed in the same way, but is likely to be applied differently. This is on the basis of there being a distinction made between executive and non-executive directors, as to both the knowledge, skills and experience that they are reasonably expected to have and the knowledge that they do, in fact, have.

Q7. What role should policyholders play in the running of mutual life companies? Are there practical barriers to policyholder participation in UK life mutuals? What action would be needed to allow more effective engagement?

The question refers to “policyholders” and “running”. Essentially policyholders who are members should participate in the management of a mutual in the same way – and to the same extent – in which shareholders participate in the management of a proprietary company. The management of both proprietary companies and mutuals will generally be delegated to the Board, subject to the constitution of the company, legislation, the common law duties imposed on directors and (in certain sectors) regulation.

Mutual life companies should consult with their members, informing them of the major business decisions taken on their behalf. Members should be able to register approval or otherwise for the actions of the directors – most likely with a vote at the AGM. If members are unable to attend the AGM in person they should be able to register their views by post or electronic means. If they do not approve of the action of directors, they should vote against their re-election or propose alternative candidates, who will, of course, have to be approved by the FSA – see our reply to Question 5.

Currently proxy voting is not permitted under Royal London’s Articles of Association. An attempt to change the Articles to allow proxy voting failed at an EGM in Colchester in December 2000. An EGM is scheduled for 19 November 2004 when we hope to gain member agreement to the introduction of proxy voting. Other changes that will be proposed then will be to require written notice of all general meetings to be sent to every member (currently only newspaper advertisements are needed) and to permit electronic member communication and appointment of proxies. We plan to write to all our members ahead of the EGM explaining the changes that we will be proposing.

We have held members roadshows around the country (the attendance at which was disappointing, despite considerable efforts to publicise them in advance) and last year undertook a consultation exercise in relation to the proposed changes to our Articles. We are currently considering other measures to increase member participation, and exploring the practical issues in the establishment of some form of a membership body to provide views to the Board. We would look to consult with this body on the major issues facing the company. Given that the role of the board in the management of the company is prescribed by the Articles and by law, the role of any such body could, of course, only be consultative.

A potential concern is that the members of any representative body, unless augmented by external professionals, may lack the breadth of experience of institutional investors. Furthermore, many policyholders clearly see themselves more as customers than as owners of the business.

As we suggest in our reply to Question 11, we do not believe that it is correct to suggest that the absence of institutional shareholders means that the Board is unaccountable. We suggest that there is considerable scrutiny provided by external commentators (in the widest meaning of the term) and that this exerts

similar influence on the management of a major mutual as institutional shareholders do under the plc model, with the influential commentators having the same access to senior executives and financial data as any institutional shareholder.

Q8. Lord Penrose says that in a life mutual “...it is the policyholders who are the source of the risk capital for the enterprise.” (chapter 20, paragraph 51). What does this mean for the relationship between a mutual life office and its policyholders?

The use of the term “risk capital” here needs to be examined. What a policyholder supplies are the premiums for a specific policy, the terms of which will provide that a payment will be made to the policyholder in certain circumstances. That payment may well only be due many years in the future. Accordingly, the policyholders primary interest is the return that he or she will receive, that in turn depends upon a number of factors, such as the financial strength of the insurer, and its investment performance and the cost effectiveness with which it runs its business over the long term. This is not the same as investing in a company and thus providing “pure” risk capital where the return will depend entirely upon the success of the venture, and where there is no contractual commitment to pay anything.

This distinction can cause conflicts between shareholders (as the providers of “pure” risk capital) and policyholders in a proprietary company. Shareholders are likely to have a much shorter investment time-horizon than long-term policyholders and demand a quicker return on investment. This may not be in the overall interests of policyholders.

The absence of a conflict of interests between policyholders and shareholders is one of the advantages of the mutual structure. In the case of a mutual there is no conflict between policyholders and the owners of the business because (to a large extent) they are the same. The only potential conflict that can arise here – and we would suggest that this is unlikely to be as potentially significant as that between policyholders and shareholders – is between policyholders who are members and those who are not. The lack of membership can arise either directly from the rules of the mutual life insurer or as a result of an acquisition by a mutual of another life insurer whose policyholders will not generally acquire membership.

A board is under a duty to act in good faith in what it believes to be the best interest of the company as a whole. As part of this, the board is required to represent the interests of the company’s present and future members. Policyholders must be treated fairly and any conflict of interests that the board

perceives there to be between non-member policyholders and the overall interests of the company (and thus the members) must be managed fairly.

We have referred to the board having to resolve conflicts. This role is inherent in the responsibilities of any board in any sector and regardless of the status of the companies. Any company will have many stakeholders – for example, owners, customers, executive directors and other senior executives, staff, and the community in which the company operates – and where their interests conflict, it falls to the board to resolve them in a fair and equitable way.

The remuneration of senior executives provides a practical example of how such conflicts are managed. All the non-executive directors of Royal London are members of the remuneration committee that is responsible for developing policies for and determining the remuneration of the executive directors and other senior executives. The policy of the committee, as disclosed in the annual report and accounts, is that:

- it is in the members' interests for remuneration packages to be competitive to attract and retain people of the required calibre – policyholders and members benefit from a well managed, profitable company and this is more likely to be achieved by a quality management team who will need to be remunerated in line with the market
- total remuneration to be at the median with salaries at the mid-point between the median and the upper quartile
- incentive schemes should encourage and reward increases in the value of the business for the benefit if members.

The committee receives extensive advice on pay and benefits from external consultants who provide no other advice or services to the Royal London Group.

By this approach, the potential conflict between senior staff and the other stakeholders is managed in what the Board regards as a fair and equitable way.

Q9. Lord Penrose acknowledges that the FSA's work since 1997 "...has sought to anticipate many of the lessons that might be drawn by this inquiry, and it should come as no surprise that it has largely succeeded in that." (chapter 30, paragraph 3). In so far as corporate governance is concerned, do you agree?

The FSA has certainly made a significant contribution. But the statement is misleading to the extent that it is intended to suggest that a situation similar to that in Equitable Life prevailed in all mutual insurers and that it has only been

through the efforts of the FSA that an improvement in corporate governance has been achieved in the sector.

The issues identified by Lord Penrose as shortcomings in the governance of Equitable Life were either not present in other mutual insurers or have largely been addressed by the companies themselves as well as by FSA regulation. The major mutual life companies have generally adopted the Code, and its previous versions. This has certainly been complemented by the FSA in particular by:

- its emphasis on risk management and internal control
- the introduction of the realistic reporting regime for with-profits funds (that has gone a long way to addressing the capital adequacy questions which lay at the heart of problems within Equitable Life)
- the requirement that all firms operating a with-profits fund are now required to publish their “Principles and Practices of Financial Management” and make these available for public scrutiny.

These changes are bringing a far greater degree of transparency and accountability to mutual life insurers and should give investors a greater degree of confidence in the overall financial health of a mutual insurer.

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

With two exceptions, we do not believe that the role of the FSA should vary depending upon corporate status of regulated firms. Indeed, we suspect that the FSA itself would be reluctant to assume a greater role in the management of regulated firms. To do so could mean that it would have difficulty in discharging its other statutory responsibilities in regulating the firm.

As we have suggested already, we do however see a role for the FSA in the “comply or explain” reporting of compliance with the Code. We suggest that there should be a prescribed format for a corporate governance report that mutual insurers include in their annual report and accounts, and that this should also be sent to the FSA and published on their websites. The FSA would then be aware of the regulated firm’s corporate governance performance during the year and would be able to comment on it as part of its overall review, and during its dialogue with the company.

The second exception is set out in our reply to Question 12.

We do not believe that the FSA requires any further powers.

Q11. Listed companies are subject to the influence of their shareholders, particularly large shareholders, and the risk of takeover. What market forces are most relevant for mutual life offices? How effective are they in promoting good performance and how might they be enhanced?

The larger mutual life companies, particularly those distributing their products via independent financial advisers (“IFAs”), come under considerable external scrutiny. Most IFA firms insist on an independently determined financial strength rating before they will consider doing any business with an insurer.

Rating agencies such as Standard & Poor’s and Moody’s Investor Services (both of which provide ratings of Royal London), actuarial consultancies such as AKG and independent researchers such as Cazalet Financial Consulting all scrutinise an insurer’s products, its performance, its financial position and its strategy; and report on them in considerable detail. The ratings and opinions, and often the full reports and findings on which they are based, are readily available to IFAs and, through them, to their clients. Indeed, the internet makes much of this material readily available to members and customers. These commentators carry considerable weight in the market so that an adverse finding or a down-rating can significantly impact on levels of new and existing business.

We would suggest that the scrutiny provided by external commentators exerts similar influence on the management of a major mutual as institutional shareholders do under the plc model. Influential commentators such as S&P and Cazalet have the same access to senior executives and financial data as any institutional shareholder.

Moreover the larger mutual insurers are also subject to a good deal of media scrutiny and comment, as evidenced earlier this year when Standard Life’s future strategy came in for close examination.

It is at least debatable whether the influence of large shareholders has always been effective in promoting good performance within shareholder-owned companies. They can inject a short-term approach where the small investor may have preferred management to take a long-term view. Furthermore, the presence of institutional shareholders is no guarantee against poor performance or major failures in corporate governance as has been illustrated by a number of notable corporate disasters, including Barings, Enron, Parmalat and Independent Insurance.

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

We regard this question as referring essentially to barriers to the continued success of *existing* mutual life companies, and respond accordingly. If it is intended also to cover:

- the creation of *new* mutuals, then the minimum capital requirements pose a very real problem
- *building societies*, then – although strictly outside the scope of the review and thus our response – the applicable legislation may be seen as a barrier by those in that sector.

There are clearly factors that are exercising the boards of many long established mutuals, foremost amongst which are likely to be the difficulty of accessing capital. This is particularly relevant in the context of falling sales of with-profit products.

Consumer confidence

It is clearly in the public interest for there to be consumer confidence in the financial services industry, never more so than today with a significant proportion of the population making inadequate financial provision. Without wishing to re-open the issues, it has to be accepted that the various (so termed) "mis-selling scandals" that have applied across the sector have damaged that confidence. The mutual life insurers probably suffer too from mutual-specific criticisms, particularly in respect of Equitable Life, in view both of its seriousness and the fact that it continues to be almost constantly in the public focus.

Anything that can restore that confidence would be welcomed. We believe that consumer confidence in the mutual sector will be enhanced by awareness that there is in place a robust framework of corporate governance and greater transparency and accountability. If the review team are satisfied that there is much evidence of this already (as we believe to be the case) then it would be helpful if their report said so. This need not detract from the fact that governance can become even better – or be applied more consistently – across the sector as a result of recommendations made by the team. An official acknowledgement that progress has been made would help to counter-balance the bad news of repeated references to Equitable Life (one company's past failings) and the constant announcements by the FSA of discipline and fines.

Mutuals worthy of that confidence

Many mutual insurers are consistently among the best performers. We have included in the Appendix material based on independent research that shows how performance tables have been dominated by mutual companies – for example:

- 7 of the top 10 over ten years are mutuals
- all but 2 of the top 10 over twenty five years are mutuals
- Royal London has most top 10 appearances (37/40) in the last decade.

The comparison of the average payouts shown in the Appendix, on the basis of a male aged 30 next birthday taking out a policy with a premium of £50 per month and the policy maturing in February 2004, indicates that mutual companies out-performed proprietary companies in all five classes:

Term	Average proprietary company payout	Average mutual company payout	Difference
10	£6,897	£7,659	11.04%
15	£13,869	£16,343	17.84%
20	£26,598	£33,530	26.06%
25	£55,550	£69,416	24.96%

Competition in the public interest

Mutual companies have provided, and continue to provide, a valuable source of competition to the proprietary companies. With no shareholders, mutuals can focus on the interests of their members and other policyholders. Diversity of corporate structure is essential for a healthy and competitive financial services industry. We regard mutual life insurers and building societies as exerting an important competitive influence on the UK financial services industry.

Any diminution of this influence risks the creation of a more inefficient market and we believe that consideration should be given to assisting mutual insurers to address the issue of capital. This, as we have suggested, could have benefits in other areas by creating “professional investors” in mutuals that would be available to play the role of the institutional shareholder in a listed company.

Lack of understanding of mutuals

On a more detailed point, a problem that we have encountered in recent times is the lack of regulatory recognition of the differences between mutuals and plc’s. A number of measures have been proposed which, whilst reasonable from the perspective of a proprietary company, would make it extremely difficult for mutual insurers to operate. Chief among these have been a series of proposals concerning the use of capital.

On each occasion the proposals have been tempered to accommodate mutual structures but, in the short-term, these proposals have raised questions over the viability of mutual insurers.

It would be helpful if the FSA could consider the impact on both mutual and proprietary insurers before beginning the formal consultation process. We recommend that the FSA creates a role for an individual to check the impact of proposals on mutual insurers, or at least undertakes some pre-consultation with representatives of the mutual sector.

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

The primary force driving demutualisation now is likely to be the need for capital to support the management's desired business model. Long-term business is capital intensive and some insurers have set themselves ambitious growth targets which could not be achieved without re-capitalisation. However this is not the only approach that companies can follow. A number of companies, Royal London among them, have achieved significant size without recourse to raising capital from sources other than policyholders.

Members, of course, receive a windfall payment in the form of compensation for the loss of membership. It is probably unlikely that policyholders (including members) as at the demutualisation would suffer in terms of pay-outs under their policies...but subsequent policyholders would, of course, be competing with shareholders.

Q14. What specific governance arrangements currently apply to other financial mutuals? In what ways do their governance arrangements differ from those that apply to life mutuals? Which, if any, of the options for life mutuals could be applied more widely in the financial mutual sector? What would the consequences be?

We have already referred to building societies that have considerable similarity with life mutuals, although an important distinction is that there is nothing that applies to mutuals in quite the same way as the building society legislation. Given the extent of regulation that applies to mutuals, however, that may be a distinction of form rather than substance.

Many building societies have adopted the Code as the basis for their corporate governance. We understand that the Building Societies Association is developing guidance on those aspects of the Code that are not directly applicable to their members. They too do not favour a "building society governance code" but rather

modifications to the part of the Code that cannot apply to building societies. This is all very much along the lines of the approach that we favour.

It may well be helpful if the modifications to the Code in relation to building societies and life mutuals should be prepared together, thereby achieving as much commonality as possible.

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

Affinity group mutual life firms may well find member involvement easier to sustain. There is greater commonality of interest, with members sharing a trade or profession, as well as pooling risks with each other in the form of life insurance. Communication with members may be facilitated by the company being able to use existing networks and structures that have been established as part of the profession or trade. This may mean that an affinity-based mutual has closer contact with its owners and they have a greater say in governance.

We sense that – we have no direct experience – this could perhaps contribute to a less developed formal structure of corporate governance being in place.

Q16. Are you aware of effective governance regimes for life (or other) mutuals in other countries? Is this the result of a formal (regulatory or government) requirement or is it voluntary, driven by the industry? Are there aspects of the arrangements in other countries that it would be desirable and practical to adopt in the UK?

We cannot speak with any authority on this. We understand that the review has approached the International Cooperative and Mutual Insurance Federation (“ICMIF”) for input of the way in which mutuals operate in other countries. We would refer you to their response.

Appendix

Comparison of pay-outs: mutuals and proprietary companies

February 2004

- Data supplied by *Money Management*
- Based on a male aged 30 next birthday taking out a policy and paying a premium of £50 per month
- The tables show actual results as at 1st February 2004
- Only companies who agreed to participate in the *Money Management* survey are included
- Key:
 - M = Mutual - incorporated under the Companies Act
 - F = Mutual - Friendly Society
 - C = Co-operative
 - P = Proprietary Company
- Refuge Assurance and Scottish Life are now part of the Royal London Group but had only been so for some 3 years at the date of the survey.
- *Money Management* refer to Refuge Assurance as a mutual. This is not correct – Refuge has always been a proprietary company and we have re-classified it accordingly
- *Money Management* exclude Healthy Investment from their published results in the interests of historical consistency. We have included them. Formerly known as Rechabite Friendly Society, Healthy Investment outperform everyone over 10, 15 and 20 years are new to the survey. Until July 2003 they were open only to teetotallers. They have recently extended their membership to include 'moderate drinkers' (people who comply with the Government-recommended maximum of 14 units of alcohol per week for women and 21 units for men) although teetotallers still receive preferential rates with 3% higher sum assured. This change is recent and the figures still reflect its preferential rates.

Past performance is not an indication of future performance

Top Ten	10 years £	Rank
F Healthy Investment	10,404	1
F Liverpool Victoria	9,154	2
P Scottish Equitable	8,168	3
F Red Rose	7,820	4
F Scottish Friendly	7,515	5
M Royal London	7,391	6
P Britannic Assurance	7,390	7
M Children's Mutual	7,381	8
F Teachers Provident	7,312	9
P Scottish Amicable	7,237	10
F Royal Liver	7,179	11
M Standard Life	7,098	12
P Refuge	7,078	13
P Ecclesiastical	7,061	14
P Prudential	7,058	15
M Wesleyan	6,993	16
P Legal & General	6,922	17
M NFU Mutual	6,869	18
P CGU	6,857	19
P Scottish Life	6,837	20
P Norwich Union	6,815	21
C CIS	6,790	22
P Clerical Medical	6,519	23
P Friends Provident	6,494	24
P Scottish Provident	6,460	25
P Scottish Mutual	6,426	26
P Scottish Widows	6,139	27

Top Ten	15 years £	Rank
F Healthy Investment	23,232	1
F Liverpool Victoria	20,095	2
F Red Rose	17,336	3
F Scottish Friendly	16,685	4
M Royal London	16,528	5
P Scottish Equitable	15,799	6
P Guardian	15,651	7
M Children's Mutual	15,602	8
M Standard Life	15,021	9
M NFU Mutual	15,009	10
P Scottish Amicable	14,760	11
M Wesleyan	14,671	12
P Scottish Mutual	14,306	13
P Prudential	14,234	14
C CIS	14,147	15
F Teachers Provident	14,078	16
P Refuge	14,075	17
P Ecclesiastical	13,996	18
P CGU	13,849	19
P Britannic Assurance	13,841	20
P Legal & General	13,811	21
M Royal Liver	13,707	22
P Clerical Medical	13,497	23
P Scottish Provident	13,437	24
P Norwich Union	13,295	25
P Scottish Life	13,032	26
P Scottish Widows	12,161	27
P Friends Provident	12,153	28

Top Ten	20 years £	Rank
F Healthy Investment	47,287	1
F Liverpool Victoria	41,751	2
F Red Rose	38,083	3
M Royal London	36,473	4
M Wesleyan	33,403	5
F Scottish Friendly	32,656	6
M NFU Mutual	30,748	7
P Guardian	29,674	8
M Standard Life	29,593	9
M Children's Mutual	29,548	10
P Scottish Equitable	29,502	11
P Ecclesiastical	28,780	12
P Britannic Assurance	28,763	13
C CIS	28,173	14
M Royal Liver	28,151	15
P Scottish Mutual	27,838	16
P Scottish Amicable	27,291	17
F Teachers Provident	26,492	18
P CGU	26,416	19
P Legal & General	26,188	20
P Prudential	26,162	21
P Friends Provident	25,985	22
P Scottish Provident	25,881	23
P Refuge	25,810	24
P Norwich Union	24,940	25
P Clerical Medical	24,672	26
P Scottish Life	24,671	27
P Scottish Widows	22,998	28

Top Ten	25 years £	Rank
F Liverpool Victoria	88,383	1
F Red Rose	88,090	2
M Royal London	78,190	3
M Wesleyan	75,305	4
F Healthy Investment	72,836	5
M Children's Mutual	71,745	6
M NFU Mutual	66,910	7
P CGU	62,832	8
M Standard Life	62,603	9
P Ecclesiastical	62,419	10
C CIS	62,186	11
P Britannic Assurance	61,659	12
F Scottish Friendly	59,422	13
Guardian	57,427	14
P Scottish Mutual	56,910	15
P Prudential	56,797	16
P Scottish Equitable	56,141	17
P Clerical Medical	55,450	18
P Friends Provident	54,984	19
P Scottish Life	54,938	20
F Teachers Provident	54,452	21
P Norwich Union	53,770	22
P Legal & General	53,588	23
M Royal Liver	52,864	24
P Scottish Amicable	52,293	25
P Scottish Provident	51,005	26
P Refuge	49,811	27
P Scottish Widows	48,774	28