



## **AFM Consultation on changes to the annotated corporate governance code**

October 2018

## About this consultation

This consultation has been prepared to enable us to engage with stakeholders about the approach we take to corporate governance amongst AFM's members. Our aim is to set out proposals for a change to our current corporate governance code by the end of 2018, with a view to our members implementing the revised approach during 2019, for accounts published in 2020 (the current annotated Code remains the source of 2018/19 reporting).

In light of these timescales, the consultation will run for one month, to 15 November 2018.

We welcome feedback from any interested parties, but in particular we welcome comments from our members and other mutual organisations, members of mutuals, and regulatory bodies.

To respond to this consultation, please provide your comments on the questions raised, in a Word document, sent by email to [martin@financialmutuals.org](mailto:martin@financialmutuals.org).

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## About Association of Financial Mutuals and its members

The Association of Financial Mutuals (AFM) was established on 1 January 2010. Financial Mutuals are member-owned and not-for-profit organisations, many of which have operated for over 100 years, and the nature of their ownership, and the consequently lower prices, higher returns or better service that typically result, make mutuals accessible and attractive to consumers.

AFM has 49 members and represents mutual and not-for-profit insurers, friendly societies and discretionary mutuals in the UK and Ireland. Between them, UK mutuals manage the savings, protection and healthcare needs of over 30 million people, and have annual premium income of around £16 billion. For more information, go to [www.financialmutuals.org](http://www.financialmutuals.org).

## 1. The UK Corporate Governance Code annotated for Mutual Insurers

In the wake of the failure of Equitable Life in 2000, the Government undertook a series of reviews into the causes of the problems, and options to resolve them. Chief amongst these was the final report of the Myners Review of the Governance of Life Mutuals, published in 2004.

Myners made a series of recommendations for the sector and for AFM's predecessor trade bodies, to take forward. These included a requirement to produce and update an annotated version of the Combined Code (now UK Corporate Governance Code), suitable for life mutuals, along with guidance on the interpretation and application of the Code. Myners indicated that a report should be published annually on compliance with the Code.

The first version of the annotated Code was published in 2006; since then we have regularly updated the Code to ensure it is kept in line with the UK Corporate Governance Code. The latest version of the Code was published in September 2016 and is available to download from the AFM website: [annotated Code, September 2016](#), along with [guidance for members](#), last updated in 2015.

Each year since we have supported members in undertaking a review of compliance with the Code. Members report to AFM on compliance with each of the provisions within the Code (there are 54 provisions in the current version) and set out, in their report and accounts, a report on corporate governance including, in such cases where they do not comply with any aspect of the Code, an explanation why.

The results are collated and published by AFM. A copy of the report is sent to HM Treasury as well as to the Prudential Regulatory Authority (PRA), Financial Conduct Authority (FCA) and the Financial Reporting Council (FRC). We publish our report on the AFM website, along with other relevant governance work<sup>1</sup>. Mutuals who are not members of AFM may have regard to the Code, but as they do not submit to the full self-regulatory regime which is integral to our approach, they should not reference this where complying with The Companies (Miscellaneous Reporting) Regulations 2018 (which will require companies with more than 2,000 employees, or turnover of over £200 million, or a balance sheet of more than £2 billion, to state which corporate governance code, if any, it has complied with, and how)<sup>2</sup>.

In 2009, the Financial Services Authority undertook a review, commissioned by HM Treasury, of the compliance approach. The review noted the significant levels of compliance with the Code, and that explanations for non-compliance were generally reasonable, though it also noted that a firm could score well in compliance terms, but continue to attract regulatory concern about their governance arrangements. On balance though, FSA concluded that "we do not consider that this work suggests there is a need to introduce any statutory regulation to enforce provisions of the ACC (Code)".

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<sup>1</sup> See: <http://www.financialmutuals.org/mutual-governance/governance-reports>.

<sup>2</sup> <http://www.legislation.gov.uk/ukxi/2018/860/part/3/made>

## 2. The rationale for change

The Code has now been in place for over 10 years. During that time, the approach to corporate governance within the sector has been sharpened significantly, and our members now have a well-balanced approach to compliance. The clearest evidence of this is in the extensive description of corporate governance set out in the reports and accounts of most of our members.

In early 2017 we wrote to HM Treasury setting out a series of reasons why we wished to undertake a wholesale review of our current approach. Amongst the reasons for this were:

- The nature of AFM's membership: traditionally most of the assets in the UK mutual insurance sector were held within AFM membership, but following a review of our scope in 2015, the largest mutuals stood down as members, meaning that today less than 1% of the UK insurance sector is within our membership.
- Equally, the membership of AFM today encompasses mutual insurers, friendly societies, private companies limited by guarantee with non-customer members ('not-for-profits') and discretionary mutuals. Our diverse membership base means the limited annotations contained within the Code are difficult to apply for an increasing number of our members.
- In recent years, there has been significant regulatory attention to corporate governance. This includes the Solvency 2 Directive, as well as PRA's supervisory statement on board responsibilities. The Government also issued a Green Paper on corporate governance in November 2016. Much of this work overlaps with and replicates the provisions in the Code.
- With ten years plus of maintaining the Code, it is apparent that whilst many of the principles that have been established to suit the business model of large PLCs do translate to the running of small mutuals, there are also many aspects of the Code which do not transfer so well, and give organisations real operational challenges either in adopting, or in justifying why they do not adopt.

Treasury accepted this rationale, though very soon afterwards the FRC announced it was undertaking its own fundamental review of the UK Corporate Governance Code, and we concluded that we should defer our work until the FRC completed its review. The FRC's revised UK Corporate Governance Code was launched in July 2018<sup>3</sup>.

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<sup>3</sup> <https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf>

## 3. A new approach

### 3.1 What are we looking to achieve?

In deciding to revise our approach, we wanted to achieve the following objectives:

- Learn from and adopt good practice in corporate governance elsewhere;
- Ensure we do not place undue barriers on compliance, or conflict with regulatory or statutory requirements;
- Ensure new standards for our members are proportionate to their size; and
- Reflect the range of business models we support, in a way that is relevant for all our members.

### 3.2 Standard developments elsewhere

Whilst the corporate governance landscape has changed significantly in the years since we launched the annotated Code, the most significant developments we have taken account of in our review are all very recent:

- As mentioned above, the FRC undertook a widescale review of the UK Corporate Governance Code, and finalised their revised Code in July 2018. The Code has been the anchor point for our annotated Code since 2006, and anchors relevant reporting requirements, such as those required for Public Interest Entities<sup>4</sup>. The revised Code consists of five sections, 18 principles and 41 provisions.
- The PRA issued a Supervisory Statement on ‘Board Responsibilities’ in March 2016, and updated that in July 2018 to take account of the extension to insurers of the Senior Managers and Certification Regime<sup>5</sup>. There are 12 elements to the Statement, and 30 paragraphs within it.
- The FCA’s Listing Rules and Disclosure Guidance and Transparency Rules apply to listed companies, though we have found it useful in the past to retain references to them, given the overlap with the UK Corporate Governance Code.
- In response to the Government Green Paper, in June 2018 the FRC consulted on a set of corporate governance principles for large private companies, and we also wanted to take this into account in our review<sup>6</sup>. The proposals focus on six high-level principles, with 22 points of ‘guidance for consideration’ beneath.

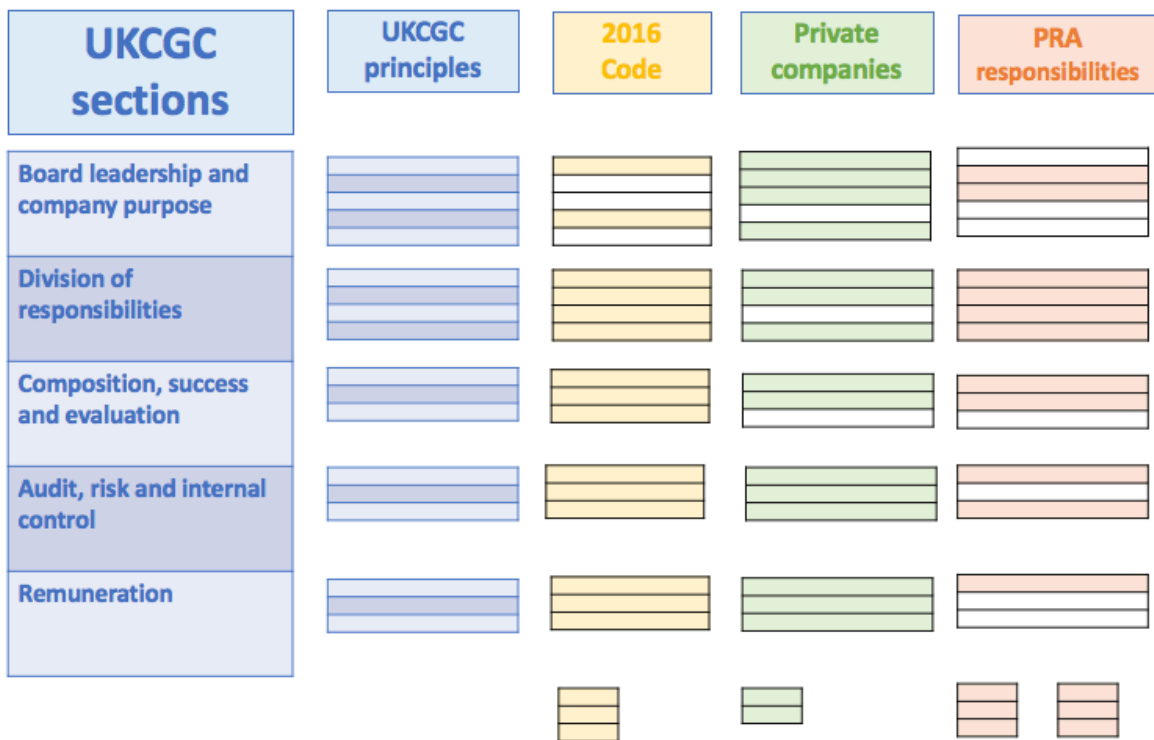
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<sup>4</sup> Under the Audit Regulation and Directive, all insurers are PIEs, with the exception of those outside the scope of Solvency 2: typically, non-directives and discretionary mutuals

<sup>5</sup> <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2018/ss516update.pdf?la=en&hash=>

<sup>6</sup> <https://www.frc.org.uk/directors/corporate-governance-and-stewardship/governance-of-large-private-companies>

We analysed all the above, to compare their coverage against the existing annotated Code. The chart illustrates in simplified form the nature of the analysis:



Using as the basis for comparison the revised Code (UKCGC, shown in blue), with its five sections and 18 principles, this shows the broad overlap with the 2016 version of the Code, where the yellow boxes are broadly dispersed in similar formation to the new principles. There are a number of new principles in the section on board leadership and company purpose that were not fully reflected in the previous Code, and some principles in the 2016 Code were not carried over (the three yellow boxes at the bottom).

Equally, whilst the high-level principles in the proposed code for large private companies are intentionally broad, the underlying guidelines provide significant overlap with the revised Code (shown in green). Similarly, the PRA responsibilities cover similar areas (in orange).

Our full analysis is available to view on request or via the AFM website.

The conclusion is that there is a high level of consistency amongst the codes and standards in place. As our members are generally authorised by the PRA<sup>7</sup>, their first priority must be to make sure they are not neglecting any standards expected by the regulator and that any Code requirement does not commit them to an approach which is inconsistent with regulatory rules.

<sup>7</sup> Discretionary mutuals are not subject to prudential regulation, and may not be authorised by PRA unless they also offer no regulated products. As a discretionary product offers non-contractual benefits, and does not equate to an insurance contract; for more see: <http://www.financialmutuals.org/files/files/Discretionary%20mutuals.pdf>.

One option we considered therefore was whether to disband our Annotated Code, and to offer further guidance and interpretation of the PRA's board responsibilities.

We concluded however that the regulation statements do not give the broadest coverage of governance standards in general: for example, they do not address responsibilities to wider stakeholders, such as the workforce or the owners of the business (members of a mutual or shareholders in a listed company). Equally, we wanted to recognise the significant investment by our members in demonstrating high standards, and in developing coherent messaging about their approach to corporate governance, primarily via their report and accounts.

So we wish to continue to support our members in interpreting good practice, and in ensuring all our members, and non-member mutual organisations that pursue a similar approach, can refer to guidance and standards that are meaningful.

## 4. Structure of a revised Code

Currently, AFM members undertake an extensive compliance exercise, reporting to AFM on a ‘comply or explain’ basis against every provision in the UK corporate governance code. The basis of this exercise is then incorporated in their report and accounts, to provide an explanation of why any provision is not complied with in full.

14. A.1.1 The board should meet sufficiently regularly to discharge its duties effectively. There should be a formal schedule of matters specifically reserved for its decision. The annual report should include a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management.

Fully complied  
 Partial/ not complied

Where complied, what is the evidence? Where you did not comply, what is the explanation?

In addition, we collect data on the structure of the board, and on board remuneration. In 2018 for the first time we also collected information from our members on the gender pay gap.

AFM produces a report each year on all the above, and this is reproduced on our website, along with other work on governance. The latest report, based on compliance in 2017, shows that on average, each member complied with 85% of the provisions in the annotated Code, and that five members fully complied with every provision and six members complied with under 70% of provisions<sup>8</sup>.

A number of members did not complete the exercise: we offer an exemption to members that joined during the year in review, and we do not extend the exercise to members with no retail customers<sup>9</sup>.

The report and accounts of AFM members bear witness to the extensive work undertaken in this exercise, which also extends to the inclusion of a strategic report and other data on the performance of the board. In all respects, the analysis provides for close comparison with the largest of FTSE 100 companies.

<sup>8</sup> This included a number of new members, who were completing the exercise for the first time.

<sup>9</sup> Non-retail customers are those who hold policies under a company name only, and who have no individually-named contract or policy schedule.



However, we did not want to position this review too narrowly, to consider simply how we retain the current approach, and simply re-focus reporting on the revised UK Corporate Governance Code.

The difference in structure between the revised UK Corporate Governance Code, and the proposed code for privately-owned companies is significant, even though, as we show above, the sum total adds up to a similar set of standards for adopters. In particular:

	<b>UK corporate governance code</b>	<b>Principles for private companies</b>
<b>Target audience</b>	Compulsory for all companies with a premium listing, such as FTSE 350 companies	Voluntary adoption for larger private companies, to comply with The Companies (Miscellaneous Reporting) Regulations 2018
<b>Structure</b>	5 overarching sections, supporting by 18 principles and 41 provisions	6 high-level principles
<b>Guidance</b>	Range of guidance provided along with reviews, along with separate stewardship code	22 supporting paragraphs with guidance to consider
<b>Compliance</b>	A combination of transparency and ‘comply or explain’: as part of their corporate governance statement, firms are expected to provide an explanation for any of the 41 provisions with which they have not complied	Transparency, with an ‘apply and explain’ approach: adopters are expected to comply with all 6 principles, and to set out in their report and accounts how they have applied them over the previous 12 months
<b>Relevance to mutuals</b>	The principles are generally recognised good practice and applicable broadly. The provisions are more structured to a listed company model, and some are difficult to apply	The principles apply in a similar fashion, and are amplified by the guidance in a less formal manner
<b>Headings</b>	<ul style="list-style-type: none"> <li>• Board leadership and company purpose</li> <li>• Division of responsibilities</li> <li>• Composition, succession and evaluation</li> <li>• Audit, risk and internal control</li> <li>• Remuneration</li> </ul>	<ul style="list-style-type: none"> <li>• Purpose</li> <li>• Composition</li> <li>• Responsibilities</li> <li>• Opportunity and Risk</li> <li>• Remuneration</li> <li>• Stakeholders</li> </ul>

Having carefully scrutinised the different approaches, we consider that the different business models and small scale of our members are better served by adapting the approach being proposed for privately-owned companies. We have therefore sought to adopt the principles set out below, and to supplement the guidance provided with issues that reflect the priorities of the business models of our members and the need to ensure boards are fully accountable to their members. We have also ensured the guidance fits with PRA’s board responsibilities, and FCA disclosure rules (for listed companies), where appropriate.

<b>1 PURPOSE</b>	An effective board promotes the purpose of an organisation, and ensures that its values, strategy and culture align with that purpose.
<b>2 COMPOSITION</b>	Effective board composition requires an effective chair and a balance of skills, backgrounds, experience and knowledge, with individual directors having sufficient capacity to make a valuable contribution. The size of a board should be guided by the scale and complexity of the organisation.
<b>3 RESPONSIBILITIES</b>	A board, and any sub-committees, should have a clear understanding of its accountability and terms of reference. The board policies and procedures should support effective decision-making and independent challenge.
<b>4 OPPORTUNITY AND RISK</b>	A board should promote the long-term success of the company by identifying opportunities to create and preserve value, and establishing oversight for the identification and mitigation of risks.
<b>5 REMUNERATION</b>	A board should promote executive remuneration structures aligned to the sustainable long- term success of an organisation, taking into account pay and conditions elsewhere in the organisation.
<b>6 STAKEHOLDERS</b>	A board has a responsibility to oversee meaningful engagement with material stakeholders, including the workforce and customers/ members, and have regard to that discussion when taking decisions. The board has a responsibility to foster good stakeholder relationships based on the organisation’s purpose.

## 5. Application of the principles- ‘apply and explain’<sup>10</sup>

Differing management and ownership structures means that a one-size-fits-all approach to corporate governance in financial mutuals is not appropriate. The draft principles seek to accommodate this by introducing a high-level approach to good corporate governance. This can be applied by any mutual, while allowing sufficient flexibility for companies to explain the application and relevance of their corporate governance arrangements.

Nothing in these principles overrides or is intended as an interpretation of directors’ duties as set out in the Companies Act 2006, sections 170-177, or of the common law fiduciary duties applicable to members of the committees of management of friendly societies. Directors’ duties include, in section 172 of the Companies Act, the duty of a director to promote the success of the company for the benefit of its members as a whole. Section 172 also sets out the matters to which directors should have regard in doing so.

Each AFM member will be expected to apply the Principles fully. Using an apply and explain approach, a mutual will be expected to provide a supporting statement for each Principle that gives an understanding of how their corporate governance processes operate and achieve the desired outcomes. The Principles are supported by non-exhaustive guidance that is intended to help in the application of the principles in practice.

Adopters of the Principles will be encouraged to demonstrate, through a written explanation in their directors’ report within their annual report and accounts, and on their website, how the application of the Principles has resulted in improved corporate governance outcomes. The AFM will support this exercise for members, and whereas the guidance provides a structure to help in developing explanations, it should not be viewed either as exhaustive or as a checklist. In this way, the explanations should provide a fair and balanced view of good governance, that is specific and relevant to the purpose and business model of the organisation.

For example, draft Principle Three states that a board should have ‘a clear understanding of its accountability and terms of reference. Its policies and procedures should support effective decision-making and independent challenge’.

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<sup>10</sup> This section is an annotated version of the application notes in [The Wates Corporate Governance Principles for Large Private Companies](#).

Mutuals could apply and explain this Principle in different ways:

- An affinity-based mutual insurer might seek to appoint an independent director to its board to introduce independent challenge. It could explain how the appointment of this director has delivered improved outcomes to its board's decision-making processes by identifying an example where the provision of independent challenge from the independent director has improved board decision-making.
- A discretionary mutual with a member board might appoint an external consultant to provide independent advice on its corporate strategy. It could describe the value that independent insight has had on refining the mutual's purpose.
- A not-for-profit company limited by guarantee may establish an advisory committee to seek independent, objective advice as to the effectiveness of the board's decision-making. It could explain how this appointment demonstrates the directors' commitment to accountability and acknowledgement of their duties under the Companies Act 2006.
- A delegate-based friendly society<sup>11</sup> might appoint a senior independent director to provide a sounding board for the chair and to serve as an intermediary for other directors and members.
- A mutual that outsources day-to-day management of its policies might set out how the directors gain comfort that operations are running properly, and set out how responsibility for oversight is retained within the board, and how the board collects relevant data to help support clear decision-making and their accountabilities.

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<sup>11</sup> A delegate based friendly society has a process where individuals are nominated to attend the AGM on behalf of other members of their branch or court, and delegates may form the majority of board directors.

## 6. The principles with supporting guidance

### PRINCIPLE ONE – PURPOSE

**An effective board promotes the purpose of an organisation, and ensures that its values, strategy and culture align with that purpose.**

#### Guidance for consideration:

- 1.1. A **well-defined purpose** will help organisations of all sizes and structures to articulate their business model, and develop their strategy, their operating practices and their approach to risk. In mutuals and not-for-profits, the purpose will establish a rationale for existence, and help ensure the organisation operates in the best interests of its members/ customers, and with its workforce and the wider public. An effective board promotes and develops its collective vision of the organisation's purpose, and can identify and explain how events or developments affecting the organisation's long-term success have been addressed.
- 1.2. An organisation's values should inform the **expected behaviours of all company employees** and the wider workforce. These values should be integrated into the different functions and operations of the business, including the organisation's internal audit, ethics, compliance and risk management functions.
- 1.3. A successful organisation should be directed by an **effective board that develops a strategy and business model to generate sustainable value**. A board is responsible for ensuring that its strategy is clearly articulated and implemented throughout the organisation, and that it, with the organisation's values, supports appropriate behaviours and practices within the organisation. This includes discouraging misconduct and unethical practices, and promoting behaviour that balances short-term needs with long-term aspirations.
- 1.4. A **healthy corporate culture** is critical to the organisation's competitive advantage, and vital to the creation and protection of long-term value. The board is responsible for fostering and maintaining the culture. Culture in a corporate context can be defined as a combination of the values, attitudes and behaviours manifested by a company in its operations and relationships with its stakeholders. The board and management must own and maintain a commitment to embedding the company's desired culture throughout the organisation.

## PRINCIPLE TWO – COMPOSITION

**Effective board composition requires an effective chair and a balance of skills, backgrounds, experience and knowledge, with individual directors having sufficient capacity to make a valuable contribution. The size of a board should be guided by the scale and complexity of the organisation.**

### Guidance for consideration:

- 2.1. The **chair leads the board** and is responsible for its overall effectiveness. The chair should be considered independent on appointment.
- 2.2. The **establishment of a balanced board** promotes strategic decision-making and ensures the delivery of an organisation's strategy. An effective board embraces diversity, promotes accountability and incorporates objective thought that promotes appropriate constructive challenge and effective decision-making.
- 2.3. **All directors should collectively demonstrate a high level of competence** relevant to the organisation's business needs and stakeholders. Organisations should demonstrate a commitment to the ongoing professional development of their board, and directors should engage with such opportunities. Between them, non-executives need to have sufficient current and relevant knowledge and experience to understand the key activities and risks in the business model.
- 2.4. Individual **evaluation of directors** should demonstrate whether each director continues to contribute effectively. This should be accompanied by an annual evaluation of the board as a whole and its committees. The chair should consider having a regular externally-facilitated board evaluation.
- 2.5. A board should give careful consideration to its size and structure so that it is sufficient to meet the strategic needs and challenges of the organisation. Board membership must be broad enough to provide for an appropriate degree of challenge and analysis, but agile enough to enable efficient and effective decision-making. An effective board should be able to demonstrate that there has been a considered effort to establish an appropriate **balance of expertise, diversity and objectivity** within its membership. Diversity characteristics a board may consider include, but are not limited to, gender, social and ethnic backgrounds, and cognitive and personal strengths.

- 2.6. **All directors should be subject to regular re-election**, with papers relating to their election setting out how their contribution is important to the organisation's long-term sustainable success. Directors that have been in place for more than nine years should be subject to annual re-election and would not count towards the minimum two independent directors required on a board. Succession plans that address the loss of key individuals should be in place.
- 2.7. Directors should have access to adequate support and time to enable them to carry out their duties. This includes the **advice of the Company Secretary**, who is responsible for advising the board on all governance matters, and for helping to ensure the Board acts in an orderly and effective fashion. The board as a whole should consider the appointment and removal of the Company Secretary.

## PRINCIPLE THREE – RESPONSIBILITIES

**A board, and any sub-committees, should have a clear understanding of its accountability and terms of reference. The board policies and procedures should support effective decision-making and independent challenge.**

### Guidance for consideration:

- 3.1. An effective board should establish and maintain corporate governance practices that provide clear lines of **accountability and responsibility** to support effective decision-making. An organisation's constitutional documents should set out procedures that govern the internal affairs of the organisation. These include matters relating to the authority, role and conduct of directors and the principal rights and responsibilities of members.
- 3.2. Strong, accountable systems for decision-making and the delineation of responsibilities ensure the organisation's members, board and senior management have clearly defined roles and decision-making powers, with **conflicts of interest appropriately managed**. Such clear corporate governance practices give insight into the stewardship of the organisation, and how the organisation's leadership works together to deliver long-term value<sup>12</sup>. Corporate governance can guide decision-making powers, assist with succession planning, and give clarity on the engagement between the organisation and its owners. Such processes are likely to be supported by the establishment of advisory or board committees, including audit<sup>13</sup>, risk, nomination, remuneration<sup>14</sup> and/ or sustainability committees, with clear terms of reference, as necessary. Board committees are accountable to the board, but should not relieve the board of any of its responsibilities.
- 3.3. Effective corporate governance practices, such as the provision of **independent challenge in board decision-making**, should mitigate the risk of unfettered powers vested in individuals. Independent challenge can allow for industry experience and objective decision-making, encouraging constructive problem-solving that benefits organisations in the long term. Organisations should consider the value that independent representation can deliver in the context of overall board

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<sup>12</sup> See the paragraph on the corporate governance statement in the previous section.

<sup>13</sup> Where a company has a dedicated audit committee, PRA's expectations if its independence are likely to be met are such that: the chair of the board is not a member, at least one member has recent and relevant financial experience, and the committee as a whole has competence relevant to the sector in which the company operates.

<sup>14</sup> The remuneration committee should consist of a minimum of two independent non-executive directors. In addition, the chair of the board can only be a member if they were independent on appointment and cannot chair the committee. Before appointment as chair of the remuneration committee, the appointee should have served on a remuneration committee for at least 12 months.



composition and organisational structure, and seek opportunities to promote independent thought in the decision-making process. This should include identifying and managing any potential conflicts of interest that could compromise objective decision-making. This is likely to be best achieved where at least half non-executive directors are considered to be independent; for small firms, there should be at least two independent non-executives.

3.4. A board should have confidence in the integrity of the **information used for decision-making and reported by an organisation**. An organisation should establish formal and robust internal processes to ensure systems and controls are operating effectively, and that the quality and integrity of information provided to the board is timely, accurate, complete and reliable, enabling directors to monitor and challenge the performance of the organisation. Boards rely on a broad range of information sources, including but not limited to:

- financial reporting;
- key performance indicators;
- workforce data;
- environmental data;
- stakeholder engagement feedback; and
- consumer data.

In some cases, this will require the design and implementation of appropriate internal control systems (such as an internal audit function). Regardless of the mechanisms put in place, a board must be satisfied there are sufficient checks and balances to ensure the integrity of the information used when taking decisions.

## PRINCIPLE FOUR – OPPORTUNITY AND RISK

**A board should promote the long-term success of the organisation by identifying opportunities to create and preserve value, and establishing oversight for the identification and mitigation of risks.**

### Guidance for consideration:

- 4.1. A board should consider and assess **how the organisation creates and preserves value over the long term**. This requires boards to consider both tangible and intangible sources of value, and the stakeholders that contribute to it. This should include an assessment of risk mitigation, as well as identifying opportunities for innovation and entrepreneurship.
- 4.2. A board has responsibility for an organisation's **overall approach to strategic decision-making and risk management**. This requires oversight of risk and how it is managed, and appropriate accountability to stakeholders, particularly with regards to conflicts of interest.

These responsibilities include:

- developing appropriate risk management systems that identify the risks facing the organisation and enable the board to make robust decisions concerning the principal risks;
- determining the nature and extent of the principal risks faced and those risks which the organisation is willing to take in achieving its strategic objectives (determining its 'risk appetite');
- agreeing on how the principal risks should be managed or mitigated to reduce the likelihood of their incidence or magnitude of their impact; and
- establishing clear internal and external communication channels on the identification of risk factors.

## PRINCIPLE FIVE – REMUNERATION

**A board should promote executive remuneration structures aligned to the sustainable long-term success of an organisation, taking into account pay and conditions elsewhere in the organisation.**

### Guidance for consideration:

- 5.1. **Appropriate and fair levels of remuneration** are imperative to enable organisations to secure high-quality directors and senior management. Alignment between the remuneration of directors and senior management and an organisation's performance should demonstrate a shared purpose and common objectives.
- 5.2. **Director and senior management remuneration should be developed around principles that align** with the organisation's **culture, values and long-term success**. These include a considered assessment of the organisation's response to matters such as its gender pay gap reporting.
- 5.3. The board should establish a clear policy on the **transparency of remuneration structures** that enable effective accountability to members/ customers. Remuneration, including benefits, for directors and senior management should consider the broader operating context of the organisation, including the pay and conditions of the wider workforce.

## PRINCIPLE SIX - STAKEHOLDERS

**A board has a responsibility to oversee meaningful engagement with material stakeholders, including the workforce and customers/ members, and have regard to that discussion when taking decisions. The board has a responsibility to foster good stakeholder relationships based on the organisation's purpose.**

### Guidance for consideration:

- 6.1. Mutuels and not-for-profit insurers create their own social, economic and environmental impact, but are also affected by changes to their operating environment. **Sustainable business** benefits wider society, and large organisations have a responsibility to create and sustain long-term value for a variety of stakeholders. This could include consideration of how an organisation's activities may impact future stakeholders.
- 6.2. The board should present a **fair, balanced and understandable assessment of the organisation's position and prospects**, and make this available to its material stakeholders on an annual basis<sup>15</sup>.
- 6.3. An organisation should identify **the stakeholder relationships that are integral to its ability to generate and preserve value** (this might include employees, owners and customers). A board should demonstrate how the organisation has undertaken effective engagement with material stakeholders and how such relationships have been taken into account in its decision-making.
- 6.4. For mutuels and not-for-profits, the workforce is a material stakeholder. Organisations should develop methods that enable them to **engage meaningfully with their workforce** and utilise such forms of engagement when taking decisions.
- 6.5. Where the organisation's policyholders are the owners of the business (ie the organisation's members), it should seek **regular engagement with its members** including, but not restricted to formal general meetings. The board should appoint one of the independent non-executives as a Senior Independent Director, to serve as an intermediary for the other directors and the members and, with other non-executives, to appraise the chair's performance.

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<sup>15</sup> To accord with the FCA Handbook rule LR 9.8.6 R (3), and as per FRC's '[guide to board effectiveness](#)', the format this might take is:

- the board should state whether it considers it appropriate to adopt the going concern basis of accounting in preparing financial statements, and identify any material uncertainties to the company's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements; and
- the board should explain in the annual report how it has assessed the prospects of the company, over what period it has done so and why it considers that period to be appropriate. The board should state whether it has a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary.

## 7. Consultation questions

1. Does the rationale for change set out in the paper address the key issues our review should be considering?
2. Are the objectives set out in section 3.1 appropriate?
3. Is the ambition to retain a 'Code for AFM members' right, or is this better positioned as a less formal set of good practice guidance?
4. Is the analysis of other Codes and regulatory requirements valid, and is anything missing?
5. Is the conclusion that aligning a Code for AFM members with that expected for large privately-owned companies, rather than listed companies, right?
6. Are the proposed Principles set at the right level to ensure they are meaningful and robust, while at the same time enabling widespread adoption by AFM members and other mutuals?
7. Does the guidance supporting each of the Principles cover the main issues AFM members should be addressing in their 'apply and explain' statements?
8. Is the proposed date for implementation, of financial years starting from 1 January 2019, reasonable?

## Annex: Added guidance on reporting and board structure

The annual report and accounts provides the basis for ‘apply and explain’ reporting, though this is only one of several important passages that AFM members should include within their report and accounts. These are largely set out in EU audit rules and UK statutory (Companies Act or Friendly Societies Act) requirements, as well as FRC’s Code and audit requirements, with further interpretation from the PRA. In particular, current accounting rules regard insurers as ‘Public Interest Entities’ (PIEs), with a resulting series of narrative reporting requirements<sup>16</sup>.

Some of the non-financial reporting requirements members should incorporate into the annual report and accounts are covered below. By including these elements in the report and accounts, an AFM member would be able to fulfil their key requirements under the Code.

Some elements overlap, and given the primary purpose of the annual report and accounts is to inform stakeholders, AFM members should consider how to present the various elements in an engaging and informative way:

### The Strategic report

The strategic report provides stakeholders with information that will enable them to assess how the directors have performed their duty to promote the success of the company. It will provide context to the financial statements that follow. All PIEs are required to produce a Strategic Report as part of the report and accounts<sup>17</sup>.

In their guidance on the strategic report, FRC provide an overview of the content of the strategic report: the following chart would apply to entities that are not PIEs, and for PIEs the middle column would be supplemented by content on anti-corruption and anti-bribery<sup>18</sup>:

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<sup>16</sup> Note that for the purposes of compliance with the Audit Regulation and Directive, and for PRA’s rules on audit requirements (<https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2016/ps1616.pdf?la=en&hash=FF769188ADEC82ABC6F62763C0A29082E393D609>), FRC and PRA accept that the term ‘insurer’ only applies to organisations within the scope of Solvency 2.

<sup>17</sup> As per The Companies Act 2006 (Strategic Report and Directors’ Report) Regulations 2013

<sup>18</sup> <https://www.frc.org.uk/getattachment/fb05dd7b-c76c-424e-9daf-4293c9fa2d6a/Guidance-on-the-Strategic-Report-31-7-18.pdf>

<b>Strategic Management</b> How the entity generates and preserves value	<b>Business environment</b> The internal and external environment in which the entity operates	<b>Business performance and position</b> How the entity has developed and performed and its position at the year end
<ul style="list-style-type: none"> <li>• Strategy</li> <li>• Business model</li> </ul>	<ul style="list-style-type: none"> <li>• Trends and factors</li> <li>• Principal risks and uncertainties</li> <li>• Environmental, employee, social, community and human rights matters</li> </ul>	<ul style="list-style-type: none"> <li>• Analysis of performance and position</li> <li>• Key Performance Indicators (KPIs)</li> <li>• Employee gender diversity</li> </ul>

The strategic report should include a viability statement, setting out the longer-term viability of the organisation, which would normally cover more than the single year view in the statement of going concern in the Directors’ report.

### Directors’ report

The directors should explain in the annual report their responsibility for preparing the annual report and accounts, and state that they consider the annual report and accounts, taken as a whole, to be fair, balanced and understandable, and to provide the information necessary for members/ owners to assess the company’s position, performance, business model and strategy<sup>19</sup>.

A list of directors during the year, as well as their attendance at meetings and their remuneration, should be included.

The ‘apply and explain’ statements relating to the six principles in the Code should be set out in this section.

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<sup>19</sup> UK Corporate Governance Code, July 2018, provision 27

## Corporate governance statement

FCA rule DTR 7.2.7 R sets out the expectations for content for a corporate governance statement, either in the directors' report within the annual report, or to be published on the website at the same time. This should set out:

- which corporate governance code the company is subject to;
- the main features of the company's internal controls and risk management systems, including a robust assessment of the company's emerging and principal risks, and how the board monitors them;
- the board's diversity policy and how it is implemented;
- the identify of independent non-executive directors;
- the responsibilities of the board and the work of the nominations, audit and remuneration committees;
- the number of board and committee meetings, and attendance by each director.

## Audit Committee

Where there is an audit committee (and otherwise within the directors' report), the annual report should describe the work of the audit committee, including<sup>20</sup>:

- the significant issues that the audit committee considered relating to the financial statements, and how these issues were addressed;
- an explanation of how it has assessed the independence and effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, information on the length of tenure of the current audit firm, when a tender was last conducted and advance notice of any retendering plans;
- in the case of a board not accepting the audit committee's recommendation on the external auditor appointment, reappointment or removal, a statement from the audit committee explaining its recommendation and the reasons why the board has taken a different position (this should also be supplied in any papers recommending appointment or reappointment);
- where there is no internal audit function, an explanation for the absence, how internal assurance is achieved, and how this affects the work of external audit; and
- an explanation of how auditor independence and objectivity are safeguarded, if the external auditor provides non-audit services.

Where there is no audit committee, the annual report should also explain how decisions are made by the Board and confirm the Chairman does not chair that part of meetings.

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<sup>20</sup> UK Corporate Governance Code, July 2018, provision 26



### Remuneration Committee

Where there is a remuneration committee (and otherwise within the directors' report), there should be a description of the work of the remuneration committee in the annual report, would include relevant aspects of the following<sup>21</sup>:

- an explanation of the strategic rationale for executive directors' remuneration policies, structures and any performance metrics;
- reasons why the remuneration is appropriate using internal and external measures, including pay ratios and pay gaps;
- a description, with examples, of how the remuneration committee has addressed the factors listed in Provision 40 of the Code;
- whether the remuneration policy operated as intended in terms of company performance and quantum, and, if not, what changes are necessary;
- what engagement has taken place with members and the impact this has had on remuneration policy and outcomes;
- what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company pay policy; and
- to what extent discretion has been applied to remuneration outcomes and the reasons why.

### Auditor's responsibilities

The auditor's report is required to state<sup>22</sup> whether, based on the work undertaken in the course of the audit, the information in the strategic report, directors' report and corporate governance statement:

- is consistent with the financial statements;
- has been prepared in accordance with applicable legal requirements; and
- contains any material misstatements.

In respect of the financial statements, the auditor's report is required to contain a clear expression of opinion on the financial statements taken as a whole. To form an opinion on the financial statements the auditor would comment as to whether:

- sufficient appropriate audit evidence has been obtained;
- uncorrected misstatements are material, individually or in aggregate;
- the financial statements, including the disclosures, give a true and fair view; and

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<sup>21</sup> UK Corporate Governance Code, July 2018, provision 41

<sup>22</sup> ISA (UK) 720 (Revised June 2016), paragraph 22D

- the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework, including the requirements of applicable law.

#### Relations with members/ conduct of the AGM<sup>23</sup>

The chair has an important role in fostering constructive relations with members and in conveying their views to the board as a whole. When called upon, the senior independent director should seek to meet a sufficient range of members in order to develop a balanced understanding of their views. Non-executive directors should take opportunities such as attendance at general and other meetings, to understand the concerns of members.

It is important that all members of a mutual are able to discharge their rights as members effectively. Formal ways of doing this are member meetings and the annual general meeting (AGM). To ensure there is sufficient time to consider the issues, the notice of the AGM and related papers should be sent at least 20 working days before the AGM.

The chairs of the audit, remuneration and nomination committees should be available to answer questions at the AGM. The chair should encourage them to make a statement on the activities and achievements of the committee over the year. This could include details of engagement with members on significant matters.

The chair has a key role to play in representing the company to its key stakeholders and is encouraged to report personally in the annual report about board leadership and effectiveness.

During the AGM, where 20 per cent or more of votes have been cast against the board recommendation for a resolution, the board should announce what actions it intends to address their concerns.

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<sup>23</sup> This may not apply to not-for-profit organisations with no membership; these notes are adapted from FRC's Guidance on Board Effectiveness