Association of Financial Mutuals

Corporate Governance Report, 2013

September 2013

0. Executive Summary

This report provides an overview of compliance with the Annotated Corporate Governance Code for Mutual Insurers (the Code) during 2012, by members of the Association of Financial Mutuals.

The annual compliance exercise for the Code requires companies to complete a detailed questionnaire which illustrates the main principles within the Code, and helps the Board of each company identify how best to comply with each aspect. Where a company does not comply with a main principle, it documents an explanation in its annual report and accounts.

Overall the stated level of compliance with the main principles in 2012 was 91.2%. The level of compliance for 2011 was 94.5% so, with the principles remaining unchanged through the year, this represents a decline in the overall stated compliance through the year.

All companies are now required to complete all sections of the questionnaire- this results from changes to the Code in 2010, which mean the sections now all have more obvious relevance to all members.

In 2012, larger AFM members reported 92.8% compliance with the principles (compared to 95% in 2011), whilst for smaller member compliance was 89.7% (against 93.5%).

So the reduction in compliance compared to 2011 was across all members, and there was also a downward trend in each of the five sections of the Code, albeit the general order was retained. This showed that members reported strongest levels of compliance on Accountability and Leadership. They were least likely to comply with the Code on the section covering Remuneration, where the absence of executive bonuses in many AFM members is contrary to practice in the listed world.

The compliance exercise also revealed that over half of the 49 AFM members reporting in full had no Board diversity policy in 2012. Many members indicated they were preparing to introduce a policy for 2013, where this is formalised in the Code along with other changes introduced during 2012. Next year's compliance exercise will formally include these changes to the Code.

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About AFM

The Association of Financial Mutuals (AFM) was established on 1 January 2010, as a result of a merger between the Association of Mutual Insurers and the Association of Friendly Societies. Financial Mutuals are member-owned organisations, 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 currently has 53 members and represents mutual insurers and friendly societies in the UK. Between them, these organisations manage the savings, protection and healthcare needs of 20 million people, and have total funds under management approaching £100 billion.

For more, go to www.financialmutuals.org.

1. Introduction

1.1 Introduction to and purpose of this paper

When formed on 1 January 2010, the Association of Financial Mutuals took over responsibility for maintaining the Annotated Corporate Governance Code for Mutual Insurers ('the Code'), and the associated annual compliance exercise, from its predecessor organisations, Association of Mutual Insurers and Association of Friendly Societies.

This paper summarises the results of the latest compliance exercise and looks ahead to changes in the Code and in the wider governance of mutuals. The intended audiences for this paper are: AFM members and HMT, as well as the two new financial regulators, the Prudential Regulatory Authority and the Financial Conduct Authority.

1.2 Purpose of the Code

The Code was developed in 2005 following the publication of the Myners Review in December 2004, which made a specific recommendation for the introduction of a version of the Combined Code for the mutual insurance sector. At the time HM Treasury and the Financial Services Authority agreed that responsibility for producing the Code and detailed guidance for their members on its implementation would rest with the predecessors of AFM.

The AFM Regulation and Governance Committee's Terms of Reference were expanded in 2012 to oversee work on the content of the Code as well as the compliance exercise.

The Code seeks to adopt wherever possible the requirements and principles of the UK Corporate Governance Code which is supervised by the Financial Reporting Council[1]. Following changes to the structure in 2010, the Code has 27 principles/ sub-principles and these are grouped into the following five sections:

Section A: Leadership
Section B: Effectiveness
Section C: Accountability
Section D: Remuneration
Section E: Relations with members

These headings reflected changes made by FRC to the UK Corporate Governance Code in 2010, which updated the principles in light of the Walker Report, and in particular altered the emphasis within the sections and removed the section on institutional shareholders, which is now part of a separate Stewardship Code. Further changes were made to the FRC Code in 2012, and these were copied across as appropriate into the Annotated Code; these will be included in next year's compliance exercise (see section 4 for details).

[1] http://frc.org.uk/Our-Work/Codes-Standards/Corporate-governance.aspx

Since late 2010 compliance with the Code has been a condition of membership of the Association of Financial Mutuals[2], though as set out in **Annex 3** there are a small number of exempted organisations each year: members that have no retail customers or that participate in other corporate governance requirements, and new members.

[2] As per the AFM constitution:
http://www.financialmutuals.org/files/files/AFM_constitution_v1_3,%20October%202012.pdf

2. Annotated Corporate Governance Code, Compliance Exercise, 2012

2.1 Methodology

Members are responsible for evaluating their compliance with the Code and for completion of a questionnaire, which gives detailed information about their compliance.

In completing this report, AFM has relied upon the information provided by members and has not attempted to validate or evaluate the submissions. We ask each member to ensure that the Code questionnaire has been approved by the Chairman, and reviewed and signed off by its Board or Committee of Management. It is also a requirement of the Code that individual companies report their compliance with the Code within their Annual Report and Accounts. Some elements of the Code are subject to review by the company's auditors.

Following the 2010 changes to the Code, we have moved to a single version of the questionnaire for all members. Previously, as certain aspects of the Code were less/ not relevant to small members, we provided a slightly abbreviated version of the questionnaire. However as good practice has increasingly concluded that size alone is not always a strong rationale for not complying with some of the principles, we have seen less reason to differentiate the questionnaire. At the margins, this has meant some additional work to adopt good practice for some organisations.

For reporting sake and to help benchmarking, we have reported on aggregate differences between small and large members. Smaller companies for the purpose of the report are defined as having gross premium income of less than £20 million per annum on average over the preceding three financial years plus assets of less than £100 million on average at the end of each of the last three years.

2.2 Results- overall

As we have seen in previous years, the level of code compliance is very high. The overall rate of compliance, at 91.2% indicates that the average member reports that they comply with almost all aspects of the Code.

The stated level of compliance for 2012 has however fallen back from the reported level for 2011 of 94.5%[3]. This is at one level surprising as some of the principles were new in 2011, but remained unchanged in 2012. One significant difference though is that a number of new or very small members reported for the first time in 2012, and some of these are continuing through a learning curve with an expectation of rapid increases in compliance over a short period.

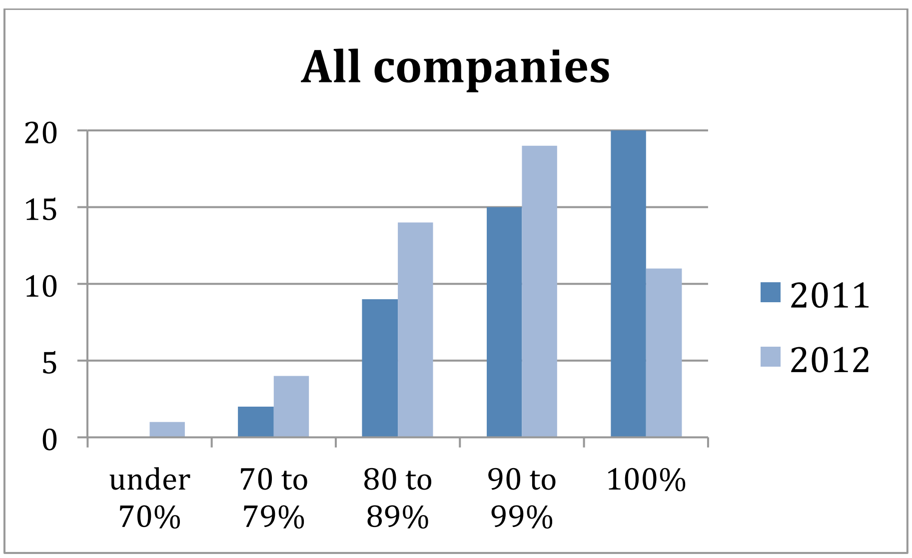
[3] http://www.financialmutuals.org/advantage/member-owned/acc-results

The results demonstrate that the strength of governance culture is such that most organisations found it relatively straightforward to incorporate most of the new principles. However not all principles, which after all were designed for large listed companies, are readily adopted, or easily incorporated into a mutual business plan. This year's results therefore demonstrate that many of those discrepancies in the underlying business model are perceived to be integral aspects of running a customer-owned organisation.

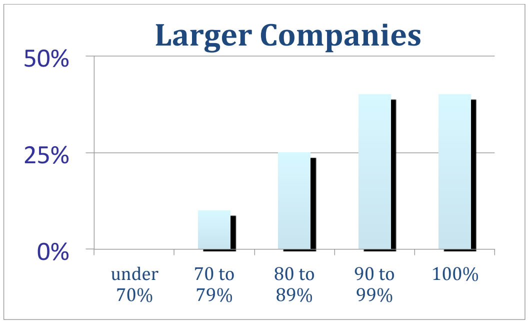
A small amount of non-compliance is therefore to be expected, and indeed the concept of comply-or-explain is built upon the expectation that variances in approaches to governance are both inevitably and necessary to retaining a diverse marketplace.

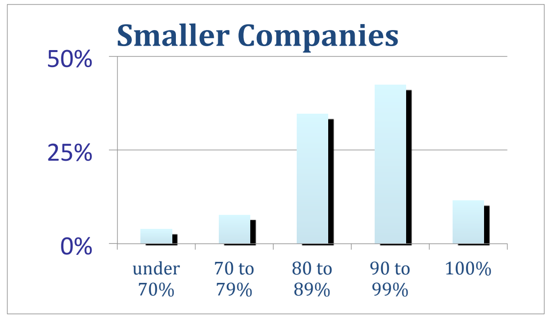
We will explore in more detail below the explanations for non-compliance, but in general terms where a firm is unable to confirm it complies with a specific principle, this reflects one or more of the following: the nature of the business; its size; the practicality of implementing some principles; or the relevance of some principles to some mutuals. **Annex 1** provides a full list of the principles and the relevant scores for 2012 and the previous year.

The chart below shows the distribution of overall scores across the 49 members that completed the full exercise for 2012. One member reported less than 70% compliance, whilst 11 respondees showed 100% compliance (compared to 20 in 2011).



49 companies completed the compliance exercise, details of which are in Annex 3. Of these, 23 came from larger companies, and 26 from smaller ones, with relevant scores for each group summarised in **Annex 2**. This compares to an even split by size in 2011 (23 large: 23 small), as a number of new and very small members are now reporting.





As the charts above show, the peak for smaller companies is in the 90 to 99% band, whilst for larger companies both the top bands were equally represented. In line with this, overall stated compliance by smaller companies was 89.7%, compared to 92.8% for larger members: both these figures are lower than 2011, and slightly lower compliance might be expected from the newer and very small organisations that make up a significant proportion of the smaller companies.

2.3 Analysis by sections of the Code

2.3.1 Section A: Leadership

This section of the Code focuses on how well the board takes collective responsibility for the long-term success of the company. There are four principles plus three sub-principles in this section, and the results obtained in the following table reflect results reported for all seven elements:

	all companies	larger companies	smaller companies	2011- all companies
Section A	96.5%	97.5%	95.6%	97.2%

The results for this section of the Code were marginally lower than for the previous year, though the difference is mainly explained by new, smaller mutuals adjusting governance culture to the expectations of the Code over time.

Every Board was satisfied that there is a clear division of responsibilities at the head of the company, between the running of the board and of the business.

Every organisation was satisfied that the Chairman demonstrated proper leadership, however around ten percent of organisations commented that whilst the Board was satisfied that the Chairman was independent on appointment, he/ she had served on the Board for more than nine years. In such cases those organisations prepared explanations within the annual report and accounts which confirmed, that the Board considered that the Chairman's appointment or continuing service was in the best interests of the organisation.

Whilst every organisation agreed that Non Executive Directors contributed constructively to, and challenged, proposals on the strategy of the organisation, a few felt that their NEDs had not been sufficiently involved in the development of strategy. Comments were made by some smaller companies on the absence of board evaluation in their organisation, or of limited detail on the activity of Board sub-committees in the annual report, to explain why they did not feel that the Board had operated entirely effectively in the year. One organisation accepted the need to develop a formal mechanism to enable NEDs to help develop future strategy.

Some smaller organisations indicated that their size or structure precluded appointment of a senior independent director, but that one of the NEDs- often the Vice-Chairman- was available to meet members as required. One friendly society, which operates on a delegate-style basis, has determined that effective dialogue should be maintained via delegates, dispensing with the role of Senior Independent Director.

Comparing larger and smaller member companies in this section, smaller members (85%) were less confident that they had accepted effectively and taken collective responsibility for the future success of the company (Principle A1; larger companies scored 100% on this principle). By comparison, 100% of smaller companies were content that the chairman was effective in all aspects of its role, compared to 91% for larger companies (Principle A3).

2.3.2 Section B: Effectiveness

This section considers the balance of skills, experience, independence and knowledge of the Board, as well as appointments to the Board and the effective operating of the Board. There are six principles and two sub-principles in this section of the ACGC, making it the most extensive in the Code. The average scores reported for 2012 were:

	all companies	larger companies	smaller companies	2011- all companies
Section B	86.7%	85.9%	87.5%	92.4%

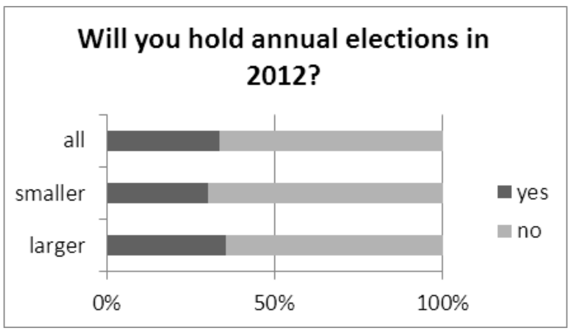
This section scored significantly lower than in 2011. This decline was slightly greater for larger companies (from 91.8%) than smaller companies (92.9%), and is the one section of the Code where smaller organisations claim higher levels of compliance.

This section also scores lower than the one on Leadership, and by a significant margin. Some of the comments made suggest that the increasing scrutiny by regulators of the effectiveness of Boards is encouraging companies to review further the composition of their Board and whether it has the right balance of skills and experience. Whilst 94% of organisations concluded the main Board had the right balance, this fell to 85% for sub-committees of the Board (Principle B1). A number of organisations where the Board has in the past been recruited from entirely within the membership have amended their rules in the recent past to allow for the recruitment of new NEDs from outside their membership, to help address concerns about skills and experience.

A number of AFM members also needed to provide explanations in relation to whether there was a formal, rigorous and transparent process for the recruitment of new directors (Principle B2). Lack of appointments, as well as scale and complexity of process proportionate to size of organisation, were cited in explanations.

A number of organisations further reported the need to constantly review the independence of some directors where they had served for more than nine years. Whilst many organisations have now changed rules to prevent directors serving for more than nine years, others are content to permit annual re-election of long-standing directors- albeit often as a precursor to change in the near future that is delivered in such a way as to avoid destabilising the organisation in the immediate term.

Similarly the sector as a whole has not been quick to embrace annual re-elections of the Board. AFM conducted research amongst members earlier in 2012, and found that at that time a third of members planned to hold elections for all directors annually- though others planned to bring this in during 2013 or 2014. This is in stark contrast to the PLC world, where the adoption of annual elections has been swift and almost complete.



The main reasons cited then and in the Code exercise were the need to avoid continuity risk or, for delegate-based friendly societies, the potential for capture from a misrepresentative group. Of those that do not conduct annual elections, the cycle of three year elections has been retained (unless the director has served over nine years)- though some friendly societies do not re-elect executive directors once they have been appointed.

Principle B7 asks 'are all directors submitted for re-election at regular intervals (subject to continued satisfactory performance)': 76% confirmed they were, down from 89% in 2011, with most of the change being within larger companies- down from 87% to just 61%. This does not though appear to signify a move away from annual elections- indeed a number of members that provided an explanation this year also confirmed that they will in future be implementing the annual re-election of all directors in 2013 or 2014. Instead, the change in the score appears to reflect a stricter interpretation by larger organisations of the question- in last year's questionnaire firms were more likely to consider a two or three year cycle as presenting 'regular intervals'. This year there is an acceptance that annual elections are best practice, and where an organisation continues to not implement these, it has answered the question in the negative.

Some organisations indicated that where they do not hold annual elections, they carefully appraise the performance of each director in the year. Principle B6 states: 'The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors'. Changes to the Code introduced in 2012 (and so for compliance in 2013 rather than for this report) put greater emphasis around effective evaluation, and include a new sub-principle: 'Evaluation of the board should consider the balance of skills, experience, independence and knowledge of the company on the board, its diversity, including gender, how the board works together as a unit, and other factors relevant to its effectiveness.'

Currently compliance with Principle B6 is given as 73%- with 78% for larger organisations and 69% for smaller. This is another significant reduction from last year, where overall compliance was 83%. The Code recognises that larger organisations should externally facilitate evaluations, and some organisations confirmed this did not take place every year, or that their annual report did not explain how this was undertaken. A number of smaller organisations have not undertake evaluations in the past, though many accept the need to now complete these- as well as the benefits to their business. Two organisations did not consider this was appropriate to their size without providing further explanation.

A number of the other Principles in this section showed lower scores than the previous year, including those relating to the knowledge and skills of Board sub-committees (Principle B1), the rigorousness and transparency of new Board appointments (B2), and the quality and timeliness of information to the Board (B5). However, in most cases this does not appear to reflect any reduction in standards within the organisation; instead organisations appear to be measuring current standards against higher benchmarks, and accepting the need to build in regular improvements over time.

On the positive side, more organisations were content that they were providing effective induction and refresher training for NEDs (Principle B4- up from 89% to 94%).

2.3.3 Section C: Accountability

The principles in this section relate to how well the Board understands the financial prospects of the organisation and the nature of the risks it is exposed to. The three principles and two sub-principles in this section enjoyed the highest levels of compliance:

	all companies	larger companies	smaller companies	2011- all companies
Section C	98.4%	99.1%	97.7%	99.6%

The high scores in this section reflect the careful attention to risk management in the sector, and have been a feature for many years. This is particularly encouraging as changes to the Code that take effect for the next report put more onus on the accuracy and fairness of reporting of the company's position, and of the role of the audit committee.

All companies were satisfied that the board takes responsibility for determining the nature and extent of the significant risks it is willing to take, in order to achieve the strategic objectives. They were also all content that the board has established formal and transparent arrangements for how they should apply financial reporting and internal controls, and that there are sound systems in place to safeguard members' interests and the company's assets. This is a similar picture to that seen in previous years.

The one area where there was less than complete compliance in this section was in relation to the Board's relationship with the company's auditors. A number of smaller organisations commented that in absence of a specific audit committee the full Board considers these issues, or that the annual report did not provide enough detail of the work of the audit committee. Changes to audit standards have been introduced recently, which will give extra focus to this area in the future, and which complement the changes made to the Code last year.

2.3.4 Section D: Remuneration

This section focuses on the levels of remuneration as well as the policy for fixing remuneration packages. There are two principles each with a sub-principle in this section, and overall it attracted the lowest scores:

	all companies	larger companies	smaller companies	2011- all companies
Section D	81.1%	89.1%	74.0%	87.5%

There was a marked deterioration in overall compliance with this section in 2012 compared to 2011, and this was mirrored by scores of both larger (from 93.5% to 89.1%) and smaller organisations (from 81.5% to 74%).

Each of the principles and sub-principles witnessed a reduction in compliance compared to the previous year, and the two that stood out most were:

- A score of 57% for the question correlating to the statement in Principle D1: 'A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance'.
- A fall in score from 96% to 80% for the question corresponding to the statement 'There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration' (Principle D2).

In relation to the first of these, 35% of smaller organisations complied, compared to 83% of larger ones. The main factor in the low compliance of smaller organisations was the absence of any performance-related pay for executives. In such circumstances, the Board has discretion over remuneration where there is no specific committee, and may review pay typically based on performance of the organisation as a whole. Some larger AFM members adopt this approach too, and remain convinced that this is consistent with the culture of the organisation and its approach to mutuality.

With regard to the second bullet above, many organisations again pointed to the absence of performance-related pay. A number of organisations indicated that the basis of engagement with members on remuneration is different to the guidance in the

Code: the Code, drawn as it is from PLCs, explores the nature of forums for significant shareholders. This is not practical for many mutuals, who therefore use the report and accounts to highlight remuneration practice, and who may include an advisory vote at the AFM to canvass views. The specific questions raised here were new in 2011, and it may also be presumed that organisations are still adjusting to them in some cases, particularly where, as mutuals, they are not affected directly by changes to company law on remuneration.

Boards were content overall then that the levels of remuneration are sufficient to attract and retain directors of the quality required to run the business successfully (Principle D1 scored 98%).

2.3.5 Section E: Relations with members

This section relates to the dialogue with members and the actions taken to encourage participation in the AGM. There are two principles and one sub-principle, with the following aggregate scores:

	all companies	larger companies	smaller companies	2011- all companies
Section E	91.8%	94.2%	89.7%	92.0%

There were high scores across each of the three principles in this section, and little change from the previous year. This indicates strong levels of adherence to the way companies seek to engage members, as owners of the organisation, in key decisions. The AGM is the central aspect of this, and is clearly a platform for member participation- some organisations indicate it has not proven successful, or is not proportionate for them to create other member forum to sit alongside this.

Many friendly societies were originally constituted on a delegate basis, and this still applies to some societies. In these cases, a proportionate number of delegates are appointed to represent the interests of members as a whole. Delegates take part in a detailed and active Annual General Meeting, which may last up to four days, where the performance and strategy of the organisation are discussed in detail. Delegates vote on a series of propositions, and this ensures that effective democracy is embraced. Members at large do not participate in the AGM and are not invited to vote on the propositions.

According to data collected for 2012, nearly 290,000 members participated in AGMs. This equates to around 3.6% of the all members- and this representatives a significant increase on the previous year, where 250,000 members voted. A proportion of friendly societies operating a delegate system- where the views of members are represented by a smaller number of delegates, and many include Child Trust Fund policyholders as members who are too young to vote. So excluding these, a more accurate figure for the number of members voting would be around 5%.

A number of organisations reported more than 10% of members voting at the AGM, whilst some of those that modified processes to make voting easier reported significant increases in the number of votes cast. This includes a number of friendly societies who have amended proxy voting rules, following new legislation that enables them to conduct electronic voting.

2.4 Reporting non-compliance

Where a company is unable to confirm it has fully complied with any one of the Code provisions during a year, it is expected to provide an explanation within the corporate governance statement in its report and accounts. The commentary on the reasons for non-compliance in the previous section is largely drawn from those statements.

The report and accounts of most AFM members are available to download from their website, although a few smaller organisations will only provide a copy to members. A review of these reports will demonstrate the significant changes in governance reporting in recent years.

The corporate governance statement itself is much more informative now, and the Code now requires a personal statement from the Chairman of a company regarding the application across the business of the principles within the Code. In early 2013 AFM provided a short paper on good practice in governance reporting from members, drawn from a review both of AFM member accounts, but also more widely[4].

However there remains scope for improvement in the explanations provided in the governance statement, where a firm has not complied with a particular aspect of the Annotated Corporate Governance Code. The FRC has also accepted this of large listed companies, providing further guidance on the clarity of explanations, and with changes it made to its Code in 2012. These will also apply to AFM members for financial years ending 31 December 2013 onwards, and put greater onus on auditors to verify that statements made in the report and accounts are fair, balanced and understandable, and consistent with the position of the organisation more generally.

The Annotated Code states that smaller firms *"may judge that some of the provisions (within the Code) are disproportionate or less relevant in their case".* The Code therefore makes clear there may be valid reasons relating to size why an organisation does not comply with certain provisions. However, we emphasis that:

- mutual insurers should be extremely careful in using size as a reason not to comply with any provision. The importance of effective formal governance structures being in place is such that only in a limited number of circumstances would the size of a company, in isolation, be a valid reason not to apply a particular Code provision;
- where size does preclude full adherence to a particular Code provision, the mutual insurer should still look to see whether the spirit of that provision could be applied in a manner with less onerous resource implications;
- "comply or explain" statements should make clear the reason why size has prevented compliance with any provision.

[4] http://www.financialmutuals.org/files/files/Examples%20of%20good%20corporate%20governance%20reporting.pdf

2.5 Conclusions

We have again seen high levels of compliance with the Code, though as we have explored above, some sections of the Code have seen lower levels of compliance in 2012 compared to 2011.

In simplistic terms though of 1,323 principles reviewed by 49 companies, 1,206- or 91.2%- were reported as having been complied with.

There have been some changes in practice by individual companies and where appropriate these are reflected in the commentary above. On the whole though performance against the Code has remained largely stable. Where overall scores are a little lower in this report than the previous year, this does not appear to reflect any regression in practice, but a more critical assessment by organisations of their approach, against the rising expectations of regulators and other stakeholders. The report also reflects the practical differences that a different business model has to delivering generally accepted good practice, where some organisations are constrained in delivering good practice, either by their rules, or more often by their cultural ethos. The AFM Board remains convinced that despite these practical challenges, it is better for the sector to benchmark performance against generally accepted good practice in the listed world, even if as a result some principles do not apply well, either due to the size of the organisation or to its business model.

Where a company has not complied with a specific principle, it has provided an explanation in its company accounts, and carried that explanation across to this compliance exercise. Each Board has been asked to sign off their report, and ought therefore to have satisfied itself that the survey represents an accurate reflection of performance, and that exceptions to the principles are appropriately described and either relevant to their business, or under review.

We have introduced an electronic signature to reinforce the need for the Chairman to take personal responsibility for approving the exercise:

> *'DECLARATION: (Q220) this summary is an accurate record of our full compliance review- including the Code questionnaire and the way results from this are transferred into comply or explain statement in the annual report. The Code questionnaire has been approved by the Chairman, and reviewed and signed off by the Board/ Committee of Management.'*

All 49 firms confirmed this was the case.

AFM does not scrutinise individual responses and remains satisfied that, as with the FRC and its approach to listed companies, the responsibility for fair and accurate reporting rests with individual Boards. As a trade body however, we run training sessions on corporate governance, produce guidance to support members, and engage constructively with regulators and policymakers on this important subject. Our NED conference held earlier this year was attended by nearly 100 people from across the sector, and we now plan to repeat this event annually[5].

In 2012 the AFM Board commissioned an independent review of the Code compliance exercise by Mazars LLP, to ensure that it continues to provide clarity to member companies on what constitutes good practice and that this report continues to reflect accurately and meaningfully the approach to governance in mutual organisations. The AFM Board accepted the recommendations of the report, and made some changes to the Code compliance exercise immediately[6]. It agreed to a more extensive overhaul of the exercise during 2013, and the revised format will be unveiled to members in October.

[5] http://www.financialmutuals.org/events/ned-events

[6] http://www.financialmutuals.org/files/files/AFM%20Governance%20Survey%2026-11-12%20Appendix%201.pdf

3. Board composition and diversity

This section reviews in greater detail some of the underlying data that supplements the Code questionnaire, on Board composition. This is covered extensively in section B of the Code on effectiveness, as well as elsewhere.

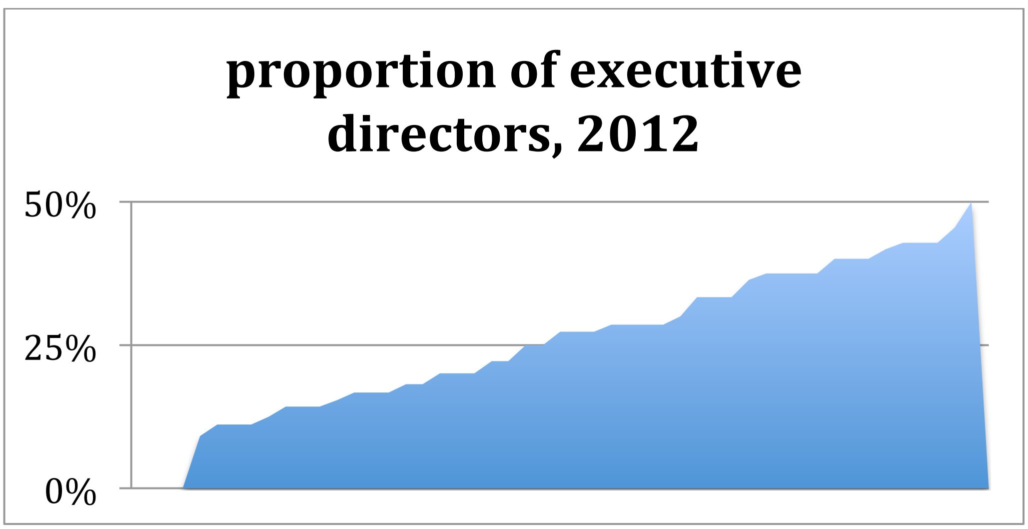
In relation to the number of Directors, we collected the following quantitative data on the breakdown of the Board:

Average number of directors	9.2 (9.7 for 2011)
Number of executive directors	2.3 (2.5)
Number of non-executive directors	6.9 (7.2)

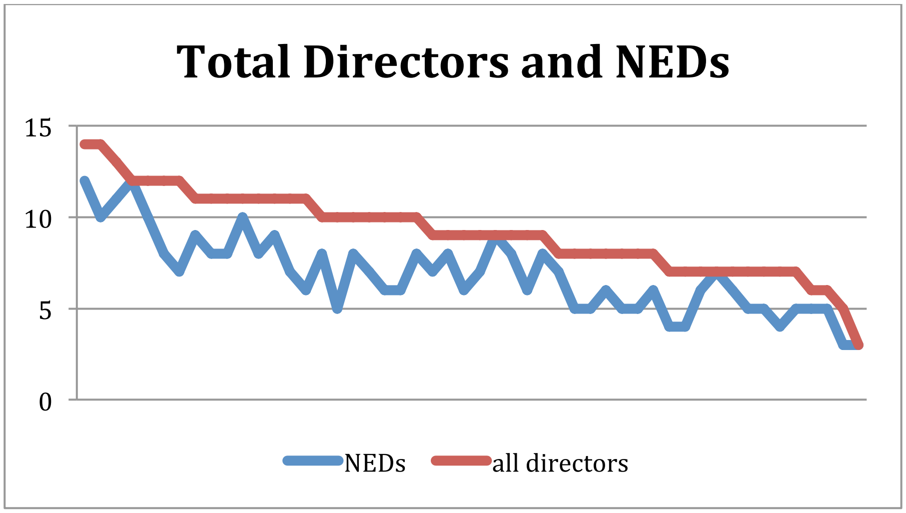
The Average number of directors reduced in 2012 by half a person on average, reflecting a reduction in the numbers employed of both NEDs and executive directors.

The results also showed considerable disparity between organisations; for example the proportion of Executive Directors on the Board ranged from zero, in companies where the managing director does not fulfill the company's rules for being a Board member, to two members that have a 50: 50 split.

As the chart below demonstrates, the majority of members have a mix between Executive and Non-Executive Directors close to the sector average of 25% (the same ratio as for 2011).

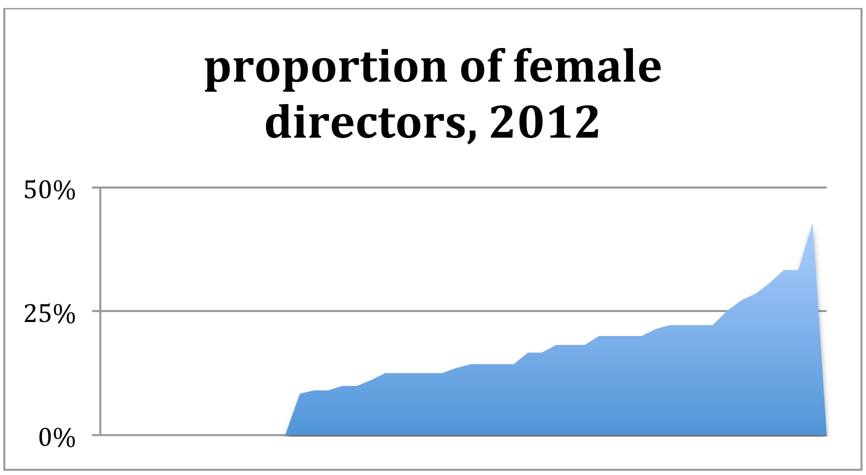


Boards ranged in size from 5 at the smallest, to 14 at the largest- the latter figure is dramatically different from last year where the largest Board had 21 directors. The average number of NEDs on the Board was 6.9, but as the following chart also shows, individual members varied from 3 up to 12 NEDs. Those particularly large Boards tend to reflect the nature and the primary source of membership of the company (in particular where there is a need to represent a range of affinity interests).



For the second time, this year we collected data from members on Board diversity (gender)- this reflects both the growing interest in this subject, and preempts the change to the Code introduced in 2012 for organisations to demonstrate that they have a Board diversity policy, and trends towards publishing more gender data.

Of the 458 Directors included in the analysis within this report, 62 were women, or 14%. In average terms, the typical Board of 7.29 Directors includes 1.25 female Directors. In 2011 12.5% of directors were female (58 in total), so this is an increase both in absolute and relative terms.



As the chart above shows, a number of AFM members already exceed the voluntary target of 25%[7]- with the largest proportion being 43%. The growth has been entirely within NEDs, where a number were recruited in the year, meaning that female NEDs now account for 15% of all NEDs; the number of women executives remained constant for the year, accounting for 10% of all executives. Further, of 51 members for which we have data 14, or more than a quarter, had no women executive or non-executive directors.

[7] This target was established by the Davies report as an aspiration for listed firms to achieve by 2015.

Comparing this to the situation in listed companies, according to Cranfield School of Management's "The female FTSE report", in December 2012 women accounted for 17.4 per cent of FTSE-100 boardroom roles, and in the FTSE 250, 12 per cent of board positions were filled by women[8]. In the second half of 2012, the percentage of appointments going to women in both the FTSE 100 and the FTSE 250 rose to 44.1 per cent and 36.4 per cent respectively, and there are only seven all-male boards left in the FTSE 100. However the report also indicates that of 22 executive appointments in the second half of 2012, only one was a woman.

We are aware that organisations are consciously considering gender diversity on their Boards, with a number of smaller organisations recently reporting difficulty in hiring suitable women executives in particular. And whilst it is encouraging that the sector is keeping pace with the listed companies, there is an argument that as organisations owned by their customers- of whom around a half must be female- there is still a way to go to be properly representative.

We asked companies to report in general terms on their board diversity policy:

- One-third indicated they have a formal diversity policy, of whom six indicated they reported against this in the remuneration committee's report in this year's report and accounts (up from 3 in 2011);
- Similarly another third indicated that they plan to introduce a gender policy in 2013;
- The final third said they had no plans to introduce a policy.

These proportions have not changed dramatically in the last 12 months, though as highlighted earlier in this report, the recent amendments to the Code added an expectation that companies have a board diversity policy and include this in their report and accounts in future. AFM aims to help members that are keen to introduce a gender diversity policy, and in 2012 provided a note for members provided by Warren Partners on good practice in the development of a Board diversity policy[9].

8 http://www.som.cranfield.ac.uk/som/dinamic-content/media/Research/Research%20Centres/CICWL/FTSEReport2013.pdf
9 http://www.financialmutuals.org/files/files/Presentation%20Diversity%20FINAL.pdf

4. Revisions to the Code

4.1 Amending the Code

A revised version of the Code was released in October 2012, to take effect for financial years commencing from 1 January 2013 onwards[10]. AFM members will therefore report on compliance against the revised Code in the first half of 2014. The main changes were:

1. Boards should confirm that the report and accounts, taken as a whole, are fair, balanced and understandable. Narrative reporting should therefore complement the figures in the financial accounts, to provide a clear and coherent portrayal of the progress of the business.

2. More informative audit committee reports, to convey to members the vital role the Audit Committee plays and the key issues it has considered through the year.

3. The Board should set out its policy on boardroom diversity.

4. There is increasing emphasis in the Code on providing appropriate explanations where a company has not complied with a Code provision in full.

FRC has recently produced guidance on revised standards for auditors, and on improving narrative reporting, and AFM is exploring how best the sector should respond to these significant new developments in governance. We will report to members by the end of 2013.

4.2 Reviewing the Code compliance exercise

In the second half of 2012 we commissioned Mazars to undertake a review of our Code compliance exercise. The AFM Board accepted in full the recommendations provided by Mazars, and undertook a number of changes to the compliance questionnaire before the end of 2012.

We also agreed to complete a more thorough revision of the compliance exercise, and commissioned work in the first half of 2013 to create a new AFM Governance microsite, with a streamlined questionnaire at its heart. The new site will be unveiled in October 2013 and will be used for compliance reporting in 2014.

[10] http://www.financialmutuals.org/advantage/member-owned/governance

5. Concluding comments

This report on corporate governance in the mutual insurance sector draws on results reported by members of the Association of Financial Mutuals to a compliance exercise focused on the UK Corporate Governance Code Annotated for Mutual Insurers.

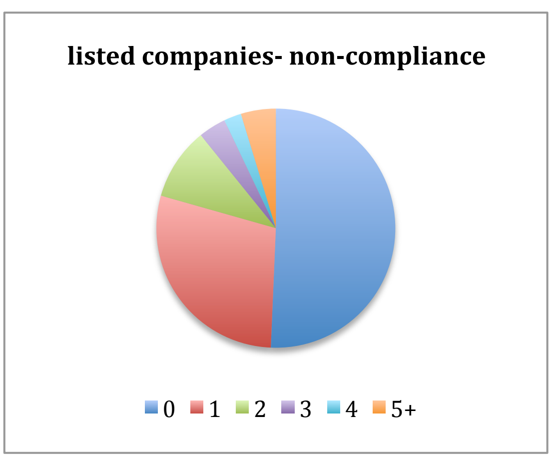
The report provides evidence of a strong commitment to high standards of governance, and that as organisations owned by their customers, companies and their boards are culturally aligned to ensuring the organisation is run in the best interests of its members- both as owners and customers.

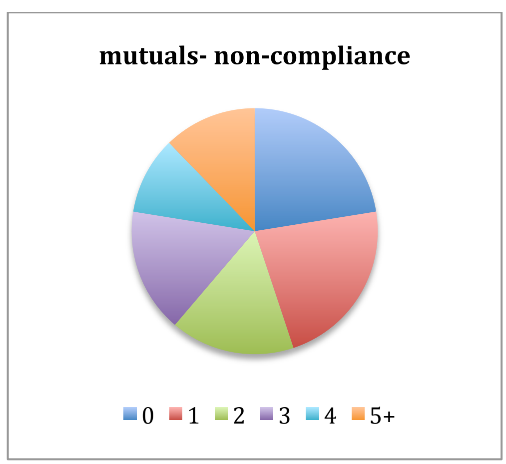
A report issued by Grant Thornton in January 2013 reviewed corporate governance standards in FTSE 350 companies[11]. The report indicated that, just as we have seen in the mutual insurance sector, the levels of compliance with the Code have not increased in recent times: around 50% of listed companies could not state full compliance with the Code.

Grant Thornton reports that most listed companies comply with all but one or two provisions in the Code, giving an overall level of compliance of 97%- a little higher than our analysis of AFM members- though of course the vast majority of firms are much larger. Indeed, the analysis indicates FTSE 100 companies are around 10% more compliant than the next 250 companies- which suggests AFM members comply at least to the extent of the FTSE 250 companies. Given the long tail of very small organisations in AFM, this has to be a very creditable result.

Listed companies have though quickly adopted new requirements for annual elections and triennial external board evaluations, with 96% and 98% respectively of FTSE 350 companies adopting these, since they were introduced as Code provisions in 2010.

Combining the Grant Thornton analysis with ours, the following comparison emerges; the charts showing the frequency of stated non-compliance with Code provisions, as a proportion of listed companies and AFM members.





[11] http://www.grant-thornton.co.uk/Global/Publication_pdf/Corporate_Governance_Review_2012.pdf

Overall the pattern is quite similar, though with a larger tail of mutual organisations unable to comply with a larger number of principles. On the whole this reflects the smaller nature of most AFM members, as well as those areas of the Code that translate less effectively to the mutual business model (such as remuneration).

Grant Thornton's report also indicated that financial services companies in the FTSE 350 publish on average ten key risks and eight key performance indicators as part of the narrative in their report and accounts. We have not undertaken similar analysis amongst AFM members.

Given the above, should we be concerned that stated levels of compliance amongst AFM members fell in 2012 to 91.2%, from 94.5% the previous year?

This year's report provides a few explanations:

- The inclusion of data from a number of organisations, including a number of new (smaller) mutuals- by necessity these organisations are undertaking changes over time to comply with the Code;
- Organisations appear to be taking a stricter line internally, applying higher expectations to themselves in some aspects of the Code;
- Whilst AFM members have changed their approach to governance significantly since the introduction of the Code, some of the principles apply less practically to mutuals than to listed companies, and in such circumstances mutuals are content to provide an explanation as to why their approach is better suited.

The main areas for continued improvement highlighted in the report are predominantly reflected in changes made to the Code in 2012. This includes:

- Work on narrative reporting, and in particular the clarity of the chairman's statement, as well as the introduction of the strategic report (to replace the business review), including the key risks and KPIs adopted by the Board;
- The effectiveness of board evaluations;
- Audit, including the enhanced role of the audit committee; and
- Board diversity policy.

Further work by AFM and members over the coming months will seek to support members in providing the highest standards of corporate governance, in reporting accurately on compliance, and in fostering a governance culture that helps promotes the values of the mutual business model.

Association of Financial Mutuals, September 2013

Annexes

1. Summary of all AFM member results
2. Overview of larger and smaller companies
3. Companies that took part in the 2012 compliance exercise

Annex 1 Summary of all AFM member results

Principle	2012- All Companies	2011- All Companies
Principle A1: (Q1) Is the Board satisfied that it has (and can demonstrate that it has) operated effectively and assumed collective responsibility for the success of the company?	92%	93%
Principle A2: (Q18) Is the board satisfied that there is a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business?	100%	100%
Principle A2a: (Q19) Is the board satisfied that no one individual had unfettered powers of decision?	94%	100%
Principle A3: (Q22) Is the board satisfied that the chairman demonstrated leadership of the board?	100%	100%
Principle A3a: (Q23) Is the board satisfied that the chairman ensured the board's effectiveness on all aspects of its role?	96%	98%
Principle A4: (Q31) Is the board satisfied that non-executive directors constructively challenge proposals on strategy?	100%	100%
Principle A4a: (Q32) Is the board satisfied that non-executive directors help develop proposals on strategy?	94%	96%
Principle B1: (Q45) Does the board have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively?	94%	93%
Principle B1a: (Q46) Do the board committees have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively?	84%	89%
Principle B2: (Q58) Is there a formal, rigorous and transparent procedure for the appointment of new directors to the Board?	86%	93%
Principle B3: (Q70) Is the Board satisfied all directors can allocate sufficient time to the company to discharge their responsibilities effectively?	94%	96%
Principle B4: (Q80) Do all directors receive induction on joining the board and do they regularly update and refresh their skills and knowledge?	94%	90%
Principle B5: (Q87) Is the board satisfied that it is supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties?	94%	100%
Principle B6: (Q99) Does the board undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors?	73%	85%
Principle B7: (Q106) Are all directors submitted for re-election at regular intervals, subject to continued satisfactory performance?	76%	89%
Principle C1: (Q110) Does the board present a balanced and understandable assessment of the company's position and prospects?	100%	98%
Principle C2: (Q116) Does the board take responsibility for determining the nature and extent of the significant risks it is willing to take in achieving the company's strategic objectives?	100%	100%
Principle C2a: (Q117) Is the board satisfied that there is in place a sound system of internal control to safeguard members' interests and the company's assets?	100%	100%

Principle C3: (Q121) Has the board established formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles?	100%	100%
Principle C3a: (Q122) Has the board established formal and transparent arrangements for maintaining an appropriate relationship with the company's auditor?	92%	100%
Principle D1: (Q144) Is the board satisfied that levels of remuneration are sufficient to attract, retain and motivate directors of the quality required to run the company successfully and that the company is not paying more than is necessary for this purpose?	98%	100%
Principle D1a: (Q145) Is a significant proportion of executive directors' remuneration structured so as to link rewards to corporate and individual performance?	57%	64%
Principle D2: (Q160) Is there a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors?	90%	93%
Principle D2a: (Q161) Can the board confirm that no director is responsible for fixing his or her own remuneration?	80%	96%
Principle E1: (Q173) Can the board confirm that: a dialogue with members takes place; and this dialogue is based on a mutual understanding of objectives?	96%	93%
Principle E1a: (Q174) Does the board as a whole take responsibility for ensuring that a satisfactory dialogue takes place?	90%	89%
Principle E2: (Q181) Does the board use the AGM to communicate with members and encourage their participation?	90%	96%

Annex 2 Overview of larger and smaller companies

Principle	Larger Companies	Smaller Companies
Principle A1: (Q1) Is the Board satisfied that it has (and can demonstrate that it has) operated effectively and assumed collective responsibility for the success of the company?	100%	85%
Principle A2: (Q18) Is the board satisfied that there is a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business?	100%	100%
Principle A2a: (Q19) Is the board satisfied that no one individual had unfettered powers of decision?	91%	96%
Principle A3: (Q22) Is the board satisfied that the chairman demonstrated leadership of the board?	100%	100%
Principle A3a: (Q23) Is the board satisfied that the chairman ensured the board's effectiveness on all aspects of its role?	96%	96%
Principle A4: (Q31) Is the board satisfied that non-executive directors constructively challenge proposals on strategy?	100%	100%
Principle A4a: (Q32) Is the board satisfied that non-executive directors help develop proposals on strategy?	96%	92%
Principle B1: (Q45) Does the board have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively?	91%	96%
Principle B1a: (Q46) Do the board committees have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively?	87%	81%
Principle B2: (Q58) Is there a formal, rigorous and transparent procedure for the appointment of new directors to the Board?	83%	88%
Principle B3: (Q70) Is the Board satisfied all directors can allocate sufficient time to the company to discharge their responsibilities effectively?	96%	92%
Principle B4: (Q80) Do all directors receive induction on joining the board and do they regularly update and refresh their skills and knowledge?	96%	92%
Principle B5: (Q87) Is the board satisfied that it is supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties?	96%	92%
Principle B6: (Q99) Does the board undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors?	78%	69%
Principle B7: (Q106) Are all directors submitted for re-election at regular intervals, subject to continued satisfactory performance?	61%	88%
Principle C1: (Q110) Does the board present a balanced and understandable assessment of the company's position and prospects?	100%	100%
Principle C2: (Q116) Does the board take responsibility for determining the nature and extent of the significant risks it is willing to take in achieving the company's strategic objectives?	100%	100%
Principle C2a: (Q117) Is the board satisfied that there is in place a sound system of internal control to safeguard members' interests and the company's assets?	100%	100%

Principle C3: (Q121) Has the board established formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles?	100%	100%
Principle C3a: (Q122) Has the board established formal and transparent arrangements for maintaining an appropriate relationship with the company's auditor?	96%	88%
Principle D1: (Q144) Is the board satisfied that levels of remuneration are sufficient to attract, retain and motivate directors of the quality required to run the company successfully and that the company is not paying more than is necessary for this purpose?	100%	96%
Principle D1a: (Q145) Is a significant proportion of executive directors' remuneration structured so as to link rewards to corporate and individual performance?	83%	35%
Principle D2: (Q160) Is there a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors?	91%	88%
Principle D2a: (Q161) Can the board confirm that no director is responsible for fixing his or her own remuneration?	83%	77%
Principle E1: (Q173) Can the board confirm that: a dialogue with members takes place; and this dialogue is based on a mutual understanding of objectives?	96%	96%
Principle E1a: (Q174) Does the board as a whole take responsibility for ensuring that a satisfactory dialogue takes place?	100%	81%
Principle E2: (Q181) Does the board use the AGM to communicate with members and encourage their participation?	87%	92%

Annex 3 Companies that took part in the 2010 compliance exercise

From the list of AFM members below, those that provided a full response to the ACC compliance exercise for 2012 are listed in blue. Companies in green are new members (none for 2011/12).

- Ancient Order of Foresters Friendly Society Limited
- Anglo-Saxons Friendly Society
- B&CE Benefit Scheme*
- Benenden Healthcare Society Ltd
- British Friendly Society Ltd
- Bus Employees' Friendly Society
- Cirencester Friendly Society Ltd
- Civil Service Healthcare Society
- Compass Friendly Society Limited
- Cornish Mutual
- CUNA Mutual*
- Dentists and General Society
- Dentists' Provident Society
- Druids Sheffield Friendly Society
- Ecclesiastical *
- Engage Mutual Assurance
- Equitable Life
- Exeter Friendly Society Ltd
- Family Investments
- Foresters Life*
- Grand United Order of Oddfellows Friendly Society
- Health Shield Friendly Society Limited
- Healthy Investment
- IPB Insurance*
- Kensington Friendly Collecting Society Ltd
- Kingston Unity Friendly Society
- Liveries Companies' Mutual*
- LV=
- Metropolitan Police Friendly Society
- MGM Advantage
- National Friendly
- Newbridge Road Assurance Society
- NFU Mutual Insurance Society Ltd
- Original Holloway Friendly Society Ltd
- Paycare
- Pharmaceutical and General Provident Society Ltd
- Police Mutual
- Railway Enginemen's Assurance Society Ltd
- Red Rose Friendly Society Ltd
- Reliance Mutual
- Royal London Insurance Group
- Scottish Friendly Assurance Society Ltd
- Sheffield Mutual Friendly Society
- Sovereign Health Care
- Sunderland Marine Mutual Insurance Company
- Teachers Assurance
- The Children's Mutual
- The Oddfellows
- The Shepherds Friendly Society Ltd
- Transport Friendly Society Ltd
- UIA (Insurance) Ltd
- Veterinary Defence Society
- Wesleyan Assurance Society
- Wiltshire Friendly Society Limited

* Organisations that have a different governance structure or overseas ownership that apply the most appropriate governance code for their circumstances.