Corporate Governance Reform Team
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AFM Response to Green Paper on Corporate Governance Reform

1. I am writing in response to this consultation paper, on behalf of the Association of Financial Mutuals. The objectives we seek from our response are to:

   - comment on the proposals in the green paper;
   - explore how governance is addressed in mutual organisations.

2. The Association of Financial Mutuals (AFM) represents insurance and healthcare providers that are owned by their customers, or which are established to serve a defined community (on a not for profit basis). Between them, mutual insurers manage the savings, pensions, protection and healthcare needs of over 30 million people in the UK and Ireland, collect annual premium income of £16.4 billion, and employ nearly 30,000 staff[1].

3. The nature of their ownership and the consequently lower prices, higher returns or better service that typically results, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. Our members include friendly societies, who have their own legislation via Treasury, as well as companies limited by guarantee.

4. In addition, FCA and PRA are required to analyse whether new rules impose any significantly different consequences for mutual businesses[2]. And via the Bank of England and Financial Services Act 2016, which provides an additional Corporate Diversity clause for FiSMA, the PRA and FCA are now required to take account of corporate diversity and the mutual business model in all aspects of their work[3].

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1 ICMIF, http://www.icmif.org/global-mutual-market-share-2013
2 Financial Services Act 2012, section 138 K: http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted
3 http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted

5. The model of corporate governance in the UK is often described as being the envy of the world. Those of us actively involved in supporting good practice will certainly recognise this description, as well as the commitment that is needed by UK firms to maintain world-leading standards. But that does not mean that governance arrangements are without fault, and there is regular press coverage of issues such as excessive executive pay, lack of transparency, exploitation and corporate tax avoidance. As the UK moves towards exiting the EU, and the government presents the UK as a good place to do business, the temptation should be avoided to soften governance requirements. In our view that would be entirely wrong, and strong corporate governance can be a cornerstone of repositioning the UK as a strong independent economy.

6. Strengthening the UK's competitive positioning, developing a new industrial strategy improving productivity, raising standards of transparency, and ensuring firms behave fairly and ethical with all their stakeholders are topical and growing challenges to corporate governance. Action on executive pay is important, but should not obscure the range of areas where governance can make an impact.

7. AFM and its members actively support effective corporate governance. Our members voluntarily apply the requirements of the UK corporate governance code, and in so doing, whilst they are small and unlisted companies, they provide evidence that good corporate governance is scalable and achievable in all organisations.

8. Our answers to the questions raised in the consultation are attached. We would welcome the opportunity to discuss further the issues raised by our response.

Yours sincerely,

Chief Executive
Association of Financial Mutuals

Responses to specific questions raised in the paper

Executive pay

1. Do shareholders need stronger powers to improve their ability to hold companies to account on executive pay and performance? If so, which of the options mentioned in the Green Paper would you support? Are there other options that should be considered?

2. Does more need to be done to encourage institutional and retail investors to make full use of their existing and any new voting powers on pay? Do you support any of the options mentioned? Are there other ideas that should be considered?

3. Do steps need to be taken to improve the effectiveness of remuneration committees, and their advisers, in particular to encourage them to engage more effectively with shareholder and employee views before developing pay policies? Do you support any of the options set out in the Green Paper? Are there any other options you want to suggest?

4. Should a new pay ratio reporting requirement be introduced? If so, what form of reporting would be most useful? How can misleading interpretations and inappropriate comparisons (for example, between companies in different sectors) be avoided? Would other measures be more effective? Please give reasons for your answer.

5. Should the existing, qualified requirements to disclose the performance targets that trigger annual bonus payments be strengthened? How could this be done without compromising commercial confidentiality? Do you support any of the options outlined in the Green Paper? Do you have any other suggestions?

6. How could long-term incentive plans be better aligned with the long-term interests of quoted companies and shareholders? Should holding periods be increased from a minimum of three to a minimum of five years for share options awarded to executives? Please give reasons for your answers.

As mutual and not-for-profit organisations, members of AFM do not have external shareholders. Our members do though strive to comply with an annotated version of the UK Corporate Governance Code, which differs from that adopted by FTSE100 companies only where necessary to fit our different business model[4]. As such our members comply or explain on all the same aspects of remuneration practice as large listed companies. In addition, each year we publish a report on board remuneration in the sector.

Our analysis of the issues raised in this chapter is limited, given that the questions raised refer to executive pay and shareholders. We can though say that from the mutual sector's perspective, absolute levels of pay are much lower than in the listed sector. A report published annual on remuneration in our sector shows that total remuneration of CEOs in our largest members in 2015 was on average £327,662. For our smaller

[4] For a full understanding of our annotated version of the UK Corporate Governance Code, see: http://www.financialmutuals.org/mutual-governance/our-governance-code

members, with revenue levels that keeps them outside the Solvency 2 Directive, average remuneration in 2015 was less than £100,000[5].

A large proportion of our members have decided not to provide any bonuses, because it is not deemed compatible with their mutual business model. Elsewhere bonus payments are not high, and advisory votes taken at the AGM have not generally demonstrated concern amongst members at the level of pay. This is despite the fact that the attendees of an AGM of a mutual are not the same as the well-informed, highly-rewarded shareholder representatives of a plc: they are ordinary members of the public, or of the trade or profession the organisation is set up to serve, for whom the levels of pay in financial services are comparatively much higher than in other sectors.

Mutual and not-for-profit insurers benefit from a business model that automatically works in the favour of members and customers (who are generally the same people), and which looks long-term. A recent survey of staff across the sector by AFM found that fewer that 8% of employees in the sector disagreed with the statement that “if this organisation were run predominantly to maximise profits for shareholders, we would do things very differently”, and 96% of employees are proud of the ethical record and reputation of their organisation[6].

The proposals being tested in the consultation recognise that the priorities of shareholder-owned companies are different, and that in the absence of a naturally long-term/ customer-focused perspective, it is necessary to provide some constraints on behaviour.

We support that process, albeit the detailed proposals as put forward do not reflect the way our members operate. That said, as our members voluntarily adopt the UK corporate governance code (in its annotated form), the further the code evolves, in order to resolve issues in the PLC world, the less relevant it becomes to our members. HM Treasury in the past has considered whether to develop a governance code for mutuals, but in the absence of that our members will continue to benchmark the PLC code. That may by necessity mean accepting that levels of non-compliance will rise, not because of any lack of desire to provide high standards, but because the standards are not relevant to our members.

That said, accountability (in the round) of the board and executive to the owners of our businesses is just as, if not more, critical to mutuals as it is PLCs. The Annual General Meeting is one way that customer-members of mutuals can have a say in the way their society is run. However, despite a great deal of work in the sector to improve AGM turnout, voting levels remain generally low, as indeed they do for individual investors in PLCs. Our member companies therefore explore a range of ways of increasing member engagement, and to thereby ensure there is proper accountability for directors. However, just like PLCs, our organisations are each unique in nature, and we would not welcome prescriptive rules built into the UK corporate governance code that have unwelcome consequences for voluntary subscribers.

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5 http://www.financialmutuals.org/files/files/2016%20Final%2029_09_16.pdf

6 http://www.financialmutuals.org/resources/new-releases/#afm-staff-survey-2016-shows-overwhelming-support-for-mutual-and-not-for-profit-ownership-and-leadership

It is the case though that the shareholders of PLCs today are largely made up of institutional and overseas investors, rather than UK individuals. One implication of this is that the largest shareholders of a large bank or insurer might be other banks and insurers: this might reduce the motivation for investors to vote down pay arrangements. To improve transparency on voting, particularly on pay, FTSE100 companies should announce the breakdown of votes by investor type.

With regard to pay ratios, we recognise that these might provide some valuable information on CEO pay, but we are also concerned that the possible results will cast ethical employers like John Lewis in a less favourable light, than banks where pay levels are very much higher. Given the relatively low levels of pay and potential reward in our sector, we do not consider the pay ratios will be particularly informative.

Strengthening the employee, customer and wider stakeholder voice

7. How can the way in which the interests of employees, customers and wider stakeholders are taken into account at board level in large UK companies be strengthened? Are there any existing examples of good practice that you would like to draw to our attention? Which, if any, of the options (or combination of options) described in the Green Paper would you support? Please explain your reasons.

8. Which type of company do you think should be the focus for any steps to strengthen the stakeholder voice? Should there be an employee number or other size threshold?

9. How should reform be taken forward? Should a legislative, code-based or voluntary approach be used to drive change? Please explain your reasons, including any evidence on likely costs and benefits.

All organisations, whether private, public or mutual, will recognise the importance of tuning in to the interests of their stakeholders. The challenge is always to ensure that the interests of owners are not pursued so vigorously such that the interests of other stakeholders are undermined.

In financial services, there are unfortunately too many examples of companies that have prioritised shareholder returns and management rewards in a way that has proved harmful to customers or other stakeholders. The £ billion paid by banks in compensation for PPI mis-selling is the clearest example of that.

Traditionally, mutual organisations have had boards that have been either entirely or partly resourced from within customer-members. This was often a result of being formed to serve the interests of a particularly community, affinity group or trade. Directors understood that their role was to represent the wider interests of members and often non-executive directors received little or no compensation for their service.

Not-for-profit insurers similarly including covenants within their constitution to support the interests of the communities they serve in. A high proportion of the surplus created in any year is thereby donated to the local community.

In either situation, it is clear to directors that their role is to ensure the business takes a long-term view on serving the interests of key stakeholders.

In recent years, increasing regulatory demands have intensified the need for boards to act professionally and to be able to bring management to account. For mutual insurers, the failure in the late 1990s of Equitable Life was largely seen as a failure of a weak board to properly hold the executive to account[7]. That trend has not however meant that the powers of member directors, or trustees, are curbed, or that they are removed from the board. Hence, most mutual insurance boards today contain a mixture of executives, representatives of the membership, and experienced, independent NEDs. In this way the boards of mutuals offer both a more professional outlook and serve the interests of the wider membership or community.

Boardroom diversity, in all forms, should be actively encouraged in organisations, as a way of demonstrating the relevance of the board and the organisation as a whole to the markets it operates in and the customers it serves.

That said, we are not convinced that all organisations should have customer or staff representatives on the board. Evidence from public services is that this can often lead to dysfunctional and excessively large boards, with divisive and competing interests preventing the board acting effectively.

Of the other options described in the green paper, many of our organisations already employ stakeholder panels. Panels of customers or staff have proved very valuable in helping to refine the strategy, improve the design of products, and to agree remuneration practice. Many of our smallest member organisations do not have the staff or customer size or finances to warrant extensive exercises, and as mentioned above, AFM has supplemented internal reviews with our survey of staff perceptions. The reference in the green paper to companies with 250 plus employees appears a sensible threshold for formalising stakeholder panels.

We also consider there is value in exploring how the strategic report can be enhanced, to provide a clearer dialogue with stakeholders about how the organisation manages their interests.

Corporate governance in large, privately-held businesses

10. What is your view of the case for strengthening the corporate governance framework for the UK's largest, privately-held businesses? What do you see as the benefits for doing so? What are the risks to be considered? Are there any existing examples of good practice in privately-held businesses that you would like to draw to our attention?

11. If you think that the corporate governance framework should be strengthened for the largest privately-held businesses, which businesses should be in scope? Where should any size threshold be set?

12. If you think that strengthening is needed how should this be achieved? Should legislation be used or would a voluntary approach be preferable? How could compliance be monitored?

13. Should non-financial reporting requirements in the future be applied on the basis of a size threshold rather than based on the legal form of a business?

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[7] http://www.kcl.ac.uk/sspp/departments/icbh/news/Equitablereport.pdf

Table 7 on page 57 of the paper included a list of 'categories of large, privately-held businesses'. This includes 'large mutuals and co-operatives', but we do not recognise the description of mutual organisations as privately owned. The ownership of mutuals is far wider than individual shareholding within listed companies, and ownership is generally open to most people who open a share account or take out a mortgage (in the case of building societies), and for policyholders in mutual insurers and friendly societies. It is not clear why the authors have provided this definition, unless the intention is to identify 'UK companies that are not in public hands and not listed', in which case the term 'privately held' is misleading and unhelpful. It is also not helpful to assume that UK companies can be conveniently separated into public-listed, privately-held and publically-held without recognising the distinct and different role of mutual organisations.

Given though that our members, and those of the BSA apply our own annotated versions of the UK Corporate Governance Code, we have addressed the questions in this section as not referring to mutuals. We would be happy to engage with BEIS on this issue if it would help their better understanding.

Applying different standards of corporate governance in privately-held businesses, purely because they have a different ownership structure, ignores the range of stakeholders the company and its board are accountable to. Customers, suppliers, staff, government authorities and society at large all rely on these organisations applying the same high standards as PLC organisations.

The audit firm governance code, as mentioned in the green paper, is a good example of how a group of privately-owned businesses within a particular sector have adapted the requirements of the UK Corporate Governance Code to fit the specifics of their business model. The Financial Reporting Council's latest version provides a useful comparison of the provisions in the audit code against those in the UK Corporate Governance Code[8]. This, and our own experience of applying the Code within small mutual organisations, demonstrates that principles in the Code relating to the role and composition of the board, and financial and business reporting can almost entirely be replicated in any business. Significantly, the audit code has no requirements relating to the other 40% of the UK Corporate Governance Code (on remuneration and shareholder relations), where the audit profession does not consider the value of significant reporting to external stakeholders is warranted.

Our own experience is similar, in that mutual and not-for-profit insurers of all sizes can adopt the main aspects of the UK Corporate Governance Code. We have found though, in utilising an annotated code which retains every aspect of the UK Corporate Governance Code, that the use of explanations of non-compliance is higher than in PLCs: in 2016, 68% of AFM members reporting not being able to comply with three or more of the Code's 58 provisions, compared to 10% of FTSE 350 companies[9].

As the Green Paper indicates, non-compliance is not in itself a sign of poor practice, and many of the aspects of the code our members provide explanations for are not ones that are necessarily appropriate for our sector. But as the Green Paper points out, if a large

[8] See Appendix B: https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Audit-Firm-Governance-Code-Revised-2016.pdf

[9] http://www.financialmutuals.org/files/files/2016%20Corporate%20Governance%20Report.pdf

proportion of the Code has to be explained away, it loses credibility. Our own discussions with external stakeholders, such as regulators and rating agencies is that, more than this, it also risks deflating perceptions of the business, or the value of the compliance process.

Based on those experiences, we suggest that the government should work with the FRC and relevant business agencies to develop a version of the UK Corporate Governance Code, revised to fit the business model of privately-held and LLP companies. We suggest this includes an expectation that the annual report includes a strategic report, a tax strategy, and a section on comply or explain. In the first instance, whilst compliance may be voluntary, we suggest companies with more than 1,000 employees should be actively incentivised to participate.

Other issues

14. Is the current corporate governance framework in the UK providing the right combination of high standards and low burdens? Apart from the issues addressed specifically in this Green Paper can you suggest any other improvements to the framework?

For financial services organisations, including members of AFM, corporate governance requirements are delivered in many ways:

- AFM runs an annual compliance exercise on its annotated corporate governance code;
- the FRC treats AFM members as voluntary subscribers to the UK Corporate Governance Code and thereby sets audit requirements we comply with;
- because insurers are classified as Public Interest Entities, regardless of size, they comply with the onerous rules in the Audit Regulations and Directive;
- legislation imposes a range of duties on directors: whilst friendly societies have their own legislation they are also drawn into some of the requirements of the Companies Act through FRC's adoption of those rules;
- a mutual's own constitution or rules may impose certain obligations on directors, relating to the specific business model or governance approach: for example, the boards of some mutuals must contain a specified number of customers or union representatives, and some mutuals operate a delegate system for AGM voting;
- the Prudential Regulatory Authority has set out its own statement on board responsibilities, with many similar principles to the FRC Code but also with some differences;
- the PRA's and Financial Conduct Authority's recent work on 'strengthening accountability' has resulted in the creation of a new Senior Insurance Managers Regime for the former, and revisions to the Approved Persons Regime by the latter;
- the Solvency 2 regime also provides significant governance arrangements for insurers.

These are all worthy attempts to ensure a strong corporate governance framework, but they also mean the scale of compliance work has increased significantly in recent years. For mutuals, often with limited resources, the extra costs of multiple and incremental compliance regimes are met by member funds, and may significantly exceed the marginal benefits to policyholders.

Hence, we welcome the focus on improving governance standards, but there is a risk that further intervention reduces the competitiveness of UK industry. Action on executive pay is important, but should not obscure the range of areas where governance can make an impact. The opportunity for UK legislators and regulators, post-Brexit, to signal that British firms will face firm- but proportionate- governance requirements, should be a vital element of making the UK an attractive place to do business.