AFM Report on Corporate Governance and Reporting in the sector, 2021

September 2022

Introduction

This report is based on a review of the 2021 year-end accounts of the majority of AFM members. In addition, a quantitative survey of members was completed, to collect additional information. The report is extensive, and provides an assessment of:

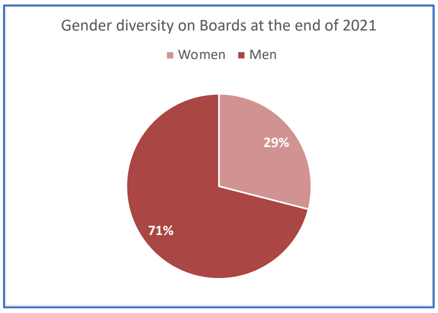
1. The overall effectiveness of report and accounts in providing a description for members of the position of their organisation. *(Page 3)*
2. The clarity of corporate governance reporting, compared to the guidance in the AFM Corporate Governance Code. *(7)*
3. An overview of board composition in AFM members. *(11)*
4. The development of climate change reporting in response to PRA's expectations that firms will have embedded their approach to managing risks, including on disclosures. *(14)*
5. An assessment of how the sector is adopting its report and accounts as a basis for describing its social impact. *(18)*
6. A review of board remuneration in 2021. *(21)*
7. A high-level overview of diversity in the sector, including the gender pay gap. *(26)*

Each chapter is followed by an 'actions to consider box', and the report is topped by some key results, and tailed with conclusions. The appendices provide an overview of the AFM Corporate Governance Code, as well as a summary of how the work was undertaken.

Key results

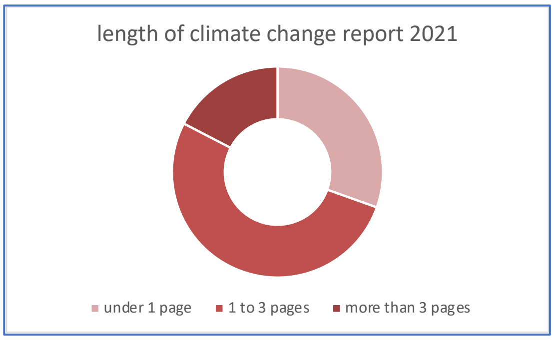
78

The average length, in pages, of report and accounts in 2021



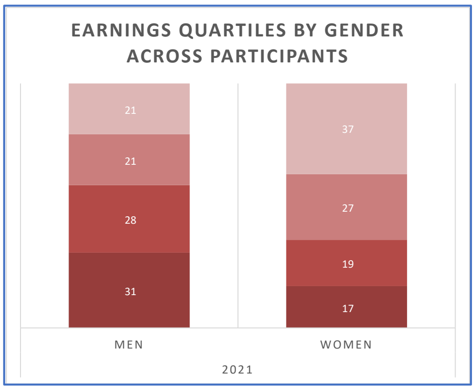
The average cost of external audit for PIEs in 2021

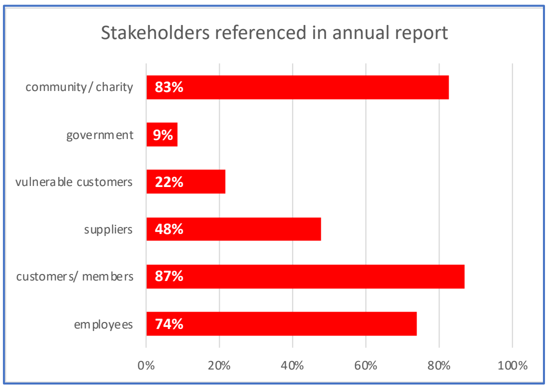
£187,200



£252,100

The average CEO total remuneration in 2021





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Number of fields of data collected for each organisation in this review

1. The overall effectiveness of report and accounts in providing a description for members of the position of their organisation

Length of annual reports

The sector has long commented on the increasing length of the report and accounts, as a result of increasingly detailed disclosures and requirements. Amongst 2021 accounts, the average (mean) length of each report was 78 pages.

Amongst small non-directives, the range was between 15 and 44, with a mean of 30, pages: that in itself was nearly 50% higher than measured for our review in 2020[1]. For Solvency 2 firms and larger non-Directives the average was 88 pages, though as the chart below shows, the page count ranged between 43 and 172.

Readability

A review of the readability of the opening page of the strategic report of a number of accounts revealed that the language used is complex. Using the Flesch reading ease score[2], most members hovered between the readability of the Financial Times, and the works of William Shakespeare. The report of course should be written to be read and be understood by, and to appeal to members, many of whom will be hard-pressed to read a strategic report scattered with jargon, let alone the denser sections later in the report.

Whilst a few organisations continue to produce a monochrome report with few or no illustrations, many organisations use a series of images and charts to reinforce what is being described in the commentary. Some of the images were evidently carefully crafted, to set out brand values for the business: one organisation included a series of quotes by the Chief Executive, no doubt collected over many years, all of them pearls of wisdom.

[1] https://financialmutuals.org/wp-content/uploads/2021/11/AFM-Code-report-on-2020-application-final.pdf
[2] https://www.thewriter.com/tools/readability

Reports that included case studies or stakeholder driven illustrations- such as charities supported by the business- came closest to evidencing the focus on members, and on making the document more readable.

Some reports were difficult to read online. For example, they didn't work on all web browsers, or the font size was small, or the page structure was locked into a playbook, or the commentary covered two or more columns. Where the primary method of distributing the report and account to members is on paper this may not present problems, and may reduce print and postage costs. However, organisations should carefully consider the member experience and the readability, where they seek to circulate the report and accounts online.

Key results

A number of reports included an early and impactful summary of key results. These were often linked to the organisation's Key Performance Indicators (KPIs), and gave an early and engaging overview of performance. Where other parts of the accounts were wordy or lacked colour, the key results page stood out and would help to engage the potential reader from the start.

For some organisations, the key results were very financially driven (i.e. growth in assets and premiums, level of profitability). For others, there was a mix between financial KPIs and those focused on customer and member satisfaction, or on the importance of teamwork.

Board effectiveness and evaluation

The AFM Corporate Governance Code (the Code)[3] stresses the importance of regular evaluation of the Board, both with regard to the performance of individuals, and to the effectiveness of the whole. Most members highlighted in their report and accounts how they undertook annual appraisals of all Board members, coordinated by the Chair, and this often involved completion of self-assessment forms.

The Code indicates externally facilitated reviews should take place regularly, and many organisations interpret this as every three years. Given the intensive nature of such reviews it is perhaps inevitable that many organisations that had planned to undertake a board effectiveness review in 2020 or 2021, had deferred it to 2022.

Sheffield Mutual and OneFamily were commendable, both for publishing outcomes of their reviews, and for setting out what action they were taking as a result. A few others referred to effectiveness reviews, but did not clearly indicate what action was taken as a result.

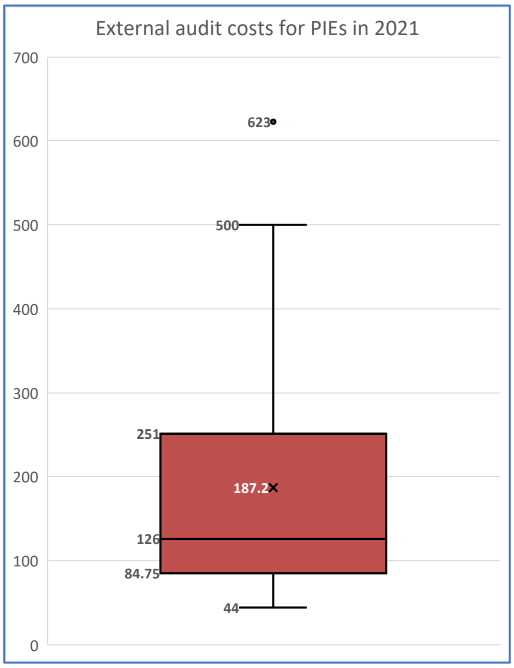
[3] https://financialmutuals.org/files/files/AFM corporate governance code, jan19(3).pdf

Audit

As part of the review for this document, the approach to audit reporting in members' accounts was explored. Audit reports have grown in length in recent years, partly as a result of requirements for the audit of Public Interest Entities (PIEs). A typical audit report now occupies around 6 pages in the annual report, though length does vary and there is no apparent correlation between the length of the report, the range of issues reviewed, and the cost of the audit. Most audits are taken by a small number of firms now, and it is apparent that each audit firm pursued a narrow list of key risks in 2021, giving the impression that each firm has a standardised approach for the year. Possibly the most extensive review was undertaken by EY for National Friendly[4] (from page 42), which agreed an extended scope, to include a review of climate change disclosures and Code application statements.

Of concern to many AFM members in recent years has been the reduction in the availability of auditors, alongside a rapid increase in price. This is particularly the case for AFM members in the scope of Solvency 2, since that also means that currently they are assessed as a PIE.

Across 19 PIEs whose accounts were reviewed, the average (mean) cost of audit in 2021 was £187,200 (marked by an X in the Box & Whisker chart). There was one outlier, excluded from the calculation of the mean, and otherwise the range was between £44,000 and £500,000. The central box in red shows that, when costs are listed in ascending order, the second lowest quartile ranges from £85,000 to the median of £126,000, with the second highest quartile up to £251,000.



Put another way, audit costs of the firms in the sample represented 0.5% of premiums earned in the year, with a range from 0.2% to 3.3%. They also equated to 24% of total remuneration costs of the Board for the entire year.

The average cost for PIEs compares to a mean for those outside the PIE regime of £12,000.

Amongst the 19 organisations in the scope of PIE, seven used one of the 'Big 4 consultancies', at an average cost of £325,000; this compares to an average of £101,000 for those using other firms. Notably, two sets of accounts commented that the firm was ceasing to use a Big 4 firm, due to price, in 2022.

Of the 23 sets of accounts reviewed, most audit reports included a review of the valuation of technical provisions and the risks of irregularities like fraud. In only one set of accounts did the auditor raise an issue of concern (relating to a past error in the accounts).

[4] https://nationalfriendly.co.uk/media/eodpk3f2/annual-report-2021.pdf

Democracy and the Annual General Meeting

Many reports made mention of the AGM and some included notice of the Meeting, and other useful information, including nominations for the Board. Holloway Friendly and The Oddfellows for example set out the vital role of the AGM in the way the business serves its members, and Scottish Friendly set out the form and benefits of their delegate system.

Elsewhere in the Strategic Report, organisations highlighted the significant changes in the constitution that members had approved in the previous 12 months, or would be asked to approve at the next AGM. A couple of reports set out earnestly the challenging operational environment for their organisation and its future prospects. Cornish Mutual's report explained how its strategy was evolving in a compelling way, whilst The Exeter was able to report that it was sharing £5.3m with its healthcare members, in light of lower than planned claims.

In our data survey, we asked how many members had voted at the 2021 AGM. Excluding those with a delegate system (where one member represents a branch or cohort of members), 3% of all members took part in the AGM. This has not changed significantly in the last 10 years, though Metfriendly achieved a very creditable 10% of members voting.

Actions to consider

- The report and accounts is getting longer, and less readable for its target audience. The former seems inevitable, the latter needs attention.
- More stand-outs, such as key results and section headings, will improve navigation and encourage readers to understand how their mutual is performing.
- The pandemic offered a reason not to undertake board effectiveness reviews, but a pattern of regular, externally facilitated reviews should be reinstated (three years being the norm).

2. The clarity of corporate governance reporting, compared to the guidance in the AFM Corporate Governance Code

The AFM Corporate Governance Code (the Code) sets high-level ambitions for how the Board of an AFM member operates, to secure good outcomes for its members and the wide range of stakeholders it supports. An overview of the Code is included in Appendix 1.

This section of the review looks at how certain aspects of members' accounts are addressed, and how clearly this provides assurance to stakeholders.

Format of Code reporting

The Code does not state what form the report on compliance should take: the decision organisations should make is what form will be most readable for members, and how best to give a fair account of how the business has applied the Code.

Most organisations included a report in either tabular form, or with short paragraphs:

- for the former, the report was typically two or three pages long, and described each principle and how it was applied;
- for the latter, the report tended to be longer and was often broken up by sub-headings that mirror the paragraphs in the Code. This allows more space to include other aspects of the corporate governance report, and signposts to where more information can be found.

Most organisations provided a clear statement to explain how they conformed with the Code, and gave an overall conclusion that they had complied during the year. Two larger organisations also stated that they sought to comply with the UK Corporate Governance Code, and used their AFM Code report to reinforce that.

A number of reports took the opportunity of Principle 6 (Stakeholder relations and engagement) to provide a description of how they engage with each of their key stakeholders, and how they ensure they are treated fairly: for example, by office moves to better accommodate staff, community donations and support, timely payments to suppliers and accountability to members. For some, this was the only focus on the S in ESG, and suggested the sector continues to undersell itself. This is considered further in another section.

Reports tended to be process-driven: confirming what actions had been taken during the year, as evidence against each of the principles, but with much less attention to the outcomes achieved. For example, some reports described new forms of member engagement or staff surveys, without describing what was learnt.

There is also limited attention to the report being forward-looking. For example, an organisation might commit to learning lessons from a board effectiveness review, without ever stating what those lessons were. A notable exception was Benenden Health, whose report provided an overview of actions taken against shortfalls it had identified in the past.

Purpose and leadership

There has been a notable increase in the way that AFM members describe their purpose, vision, or mission, both within the corporate governance report, and earlier in the annual accounts. This helps reassure members that the business is run in their best interests, and that the report is relevant to them.

Many organisations supported their purpose statement with an explanation of their culture, as well as the values of the business. There was also evidence that these are not static, and that boards review the purpose and values in line with changes to strategy.

With regard to useful elements of individual reports, Cirencester Friendly set out clearly the key areas of focus for the Board, Railway Enginemen's provided a clear account of how the purpose had evolved, and Scottish Friendly focused on actions taken.

Viability and going concern

Historically, mutuals were required to provide a statement on going concern, to set out its reasonable expectations for the prospects of the business over the next 12 months. More recently, a viability statement has been required via the Companies Act, setting out how the business will meet its liabilities and what its prospects are over a longer period. Auditors' reports are expected to comment on the going concern disclosure, and in 2021 many auditors also commented on the veracity of the longer-term viability statement.

All AFM members' accounts reviewed included a clear going concern statement, and no auditors appear to question the content of that. Few non-Directive friendly societies (i.e. those outside the scope of Solvency 2) including a variability statement, and amongst Directives, 90% provided a clear viability statement.

The most common assessment had a five-year horizon (52%), and a further 37% opted for a three-year view. Two exceptions were a two-year and four-year review, which appeared to tie in with the Board strategy. Most statements are brief, with the more expansive ones explaining what factors are taken into account or what risks are considered and/ or how the assessment correlates with the approach in the ORSA (Own Risk and Solvency Assessment).

Directors' Duties

The AFM Code highlights the need for members to demonstrate how the directors have promoted the success of the company for the benefit of its members. Directors' duties are codified in sections 170-177 of the Companies Act 2006, and in the common law fiduciary duties applicable to the committee of management of a friendly society. In addition, since 2019, Public Interest Entities (PIEs) are required to produce a Strategic Report, with a section 172(1) statement, either in the Strategic Report or on their website.

The following extract from the Code sets out what the s172 statement should include.

“1. A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:

a) The likely consequences of any decision in the long term;
b) The interests of the company’s employees;
c) The need to foster the company’s business relationships with suppliers, customers and others;
d) The impact of the company’s operations on the community and the environment;
e) The desirability of the company maintaining a reputation for high standards of business conduct; and
f) The need to act fairly as between members of the company”.

Within 2021 report and accounts, 40% of PIE members, including both companies and friendly societies, provided a s172 statement within their strategic report.

The remaining 60% of PIEs should consider whether and how to add a s172 statement in their next report and accounts, or add it to the website, or as our 2019 paper on the duties of Directors[5] states, seek their own legal advice.

The general form of s172 statement was typically a page long, and set out how the organisation had adopted each element of s172(1), and had supported the interests of a range of stakeholders. Most statements referred to other parts of the report and accounts, where more information on the action taken to support stakeholders could be found.

In the most effective statements, the focus was on setting out the social impact of the business, and on how the organisation engaged with each of their key stakeholders, why that mattered to them, and what actions were taken or planned.

For an example of an extensive s172 statement in the strategic report, see the OneFamily report[6], starting at page 20. Whilst we didn’t locate any website statements, a good example of a stand-alone social impact report can be found on Scottish Friendly’s website (see section 5 for more).

Opportunity and risk

This section of the governance report predominantly focused on risk, given that for most businesses the strategic report had already covered the business opportunities. Reports covered the organisation’s key risks and the appetite for risk; most also covered the internal control framework, and many focused on the three lines of defence. MDDUS set out clearly how relevant committees were responsible for particular risks.

[5] https://financialmutuals.org/files/files/Duties of Directors, jan19.pdf
[6] https://www.onefamily.com/assets/consumer/downloads/company-information/onefamily-annual-report-and-financial-statement-2021.pdf

Technology advances during two years of working from home have been a regular source of discussion in the sector, along with the risk of being left behind. The PRA however has emphasised that small insurers should ensure that when spending policyholder money on IT, firms should regularly re-evaluate spending. It was perhaps illuminating then that a third of organisations referenced the significant IT investments they had made in 2021. Many described how investments would provide enhanced features and experiences for members, and Metfriendly provided a section dedicated to its actions to improve technology.

Actions to consider

- Most AFM members have settled on a style of either tabular or paragraph reporting of adherence with the AFM Code; a clear and readable approach is key.
- Reports against the Code are very process-driven. Reports are not focused sufficiently on outcomes and impact.
- Public Interest Entities should consider adding an explicit viability statement and s172 report if they are not already doing so.

3. An overview of board composition in AFM members

The data for this section was supplied by members who completed our annual data survey. Past data was collated by FTI Consulting, who undertook a similar exercise in 2020 and 2021.

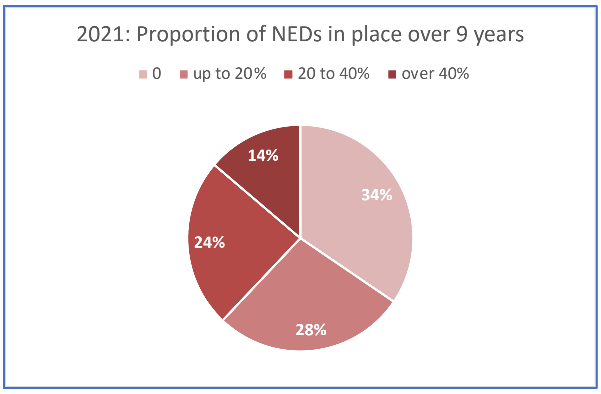
Board structure

The average Board in the sector is made up of 8.6 people: 2.1 are the Executive (24%), with the remainder made up of NEDs. Compared to the average Board five years ago, the Executive has remained constant, whilst the number of NEDs has reduced by 0.5, or 8%. This means that, with widening board responsibilities and SMCR, the greater concentration of skills now expected in NEDs is shared amongst a smaller group. The reduction in the number of NEDs may also be an attempt to reduce costs.

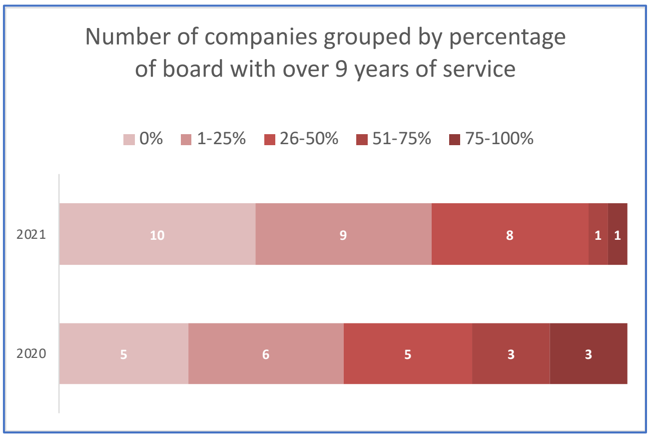
Board longevity

A question that has regularly been put to the sector relates to board longevity, and the desire for smaller mutuals to retain valuable Board members. The AFM Code stresses the need for independent challenge to, and support for, Executives, and the PRA has reaffirmed that Board Directors whose tenure exceeds best practice standards should be excluded from those eligible for being counted towards the minimum of two independent NEDs.

The generally perceived definition of best practice is nine years, and member data indicates 20% of NEDs have served longer than this. The Code anticipates some NEDs may be needed for longer than nine years, and in these circumstances, these individuals should stand for re-election annually. Our analysis reveals that only around one-third of organisations have no NED who has served longer than nine years.

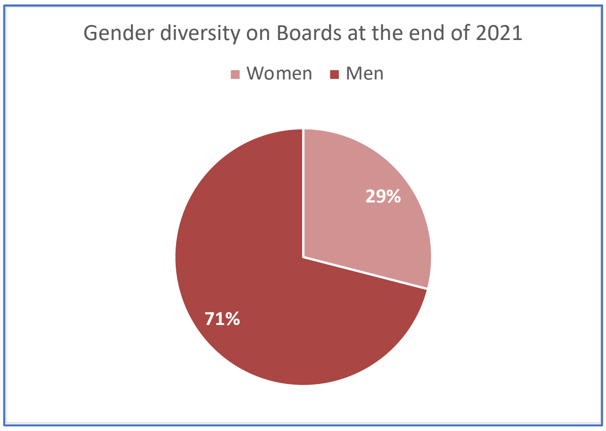


This is an improving position though, with 10 members having no long-serving Directors, compared to five 12 months earlier. Of concern however is that amongst the organisations with a number of NEDs in service for over nine years, where some of those were deemed by the business to be independent, the commentary was sparse on how independence was assured and members' best interests secured, and whether the organisation acknowledged and sought to change this situation.

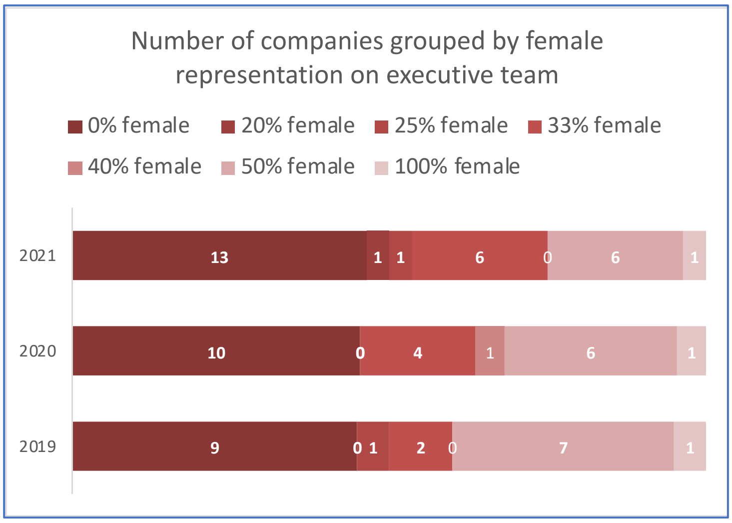


Gender diversity

A particular feature of previous reviews of Board composition has been to consider the proportion of female directors on Boards (we consider other aspects of diversity later on). Across AFM members we have seen a concerted effort to improve the gender balance on Boards: five years ago a typical board consisted of 18% women to 82% men. As the chart illustrates, this position has improved considerably.

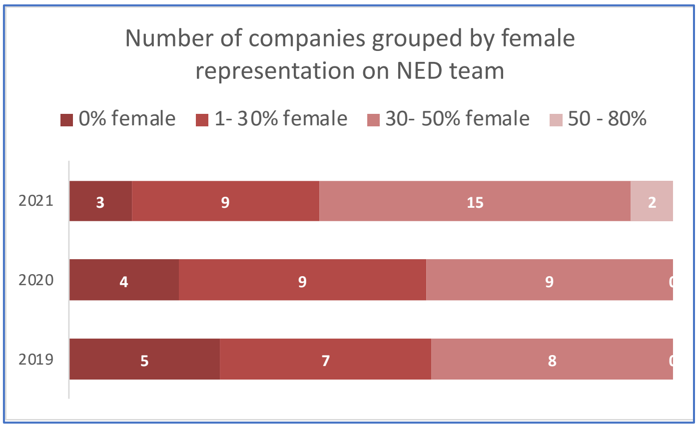


A number of AFM members are signatories to the Government's Women in Finance Charter[7], which reports female representation in senior management in the financial sector of 33% in 2021. For AFM members, the comparable figure is 26%, so the sector still has some way to go. Indeed, as the next chart demonstrates, progress is slow, and 50% of members in the sample have no female executives.



[7] https://www.gov.uk/government/news/over-400-firms-now-signed-up-to-women-in-finance-charter

Amongst non-executives, 30% of the total is female, and the chart below shows three of 29 Boards had no female NEDs (10%), compared to 25% in 2019.



The AFM Corporate Governance Code includes a principle on Board Composition (Principle 2), and our review of report and accounts found that only around 15% acknowledged that they needed to address either board longevity or diversity. The results above suggest some organisations need to either make stronger assertions on how they manage board composition, or set out what action they are taking to close gaps.

Actions to consider

- Whilst the picture is improving, Board longevity remains an issue for the sector: around one in seven boards have 40% or more NEDs who have served more than nine years, impacting independence.
- Board gender diversity has continued to improve, particularly amongst NEDs. Gender diversity amongst the executive is lower and overstated by a minority of organisations with over 50% female leaders.

4. The development of climate change reporting

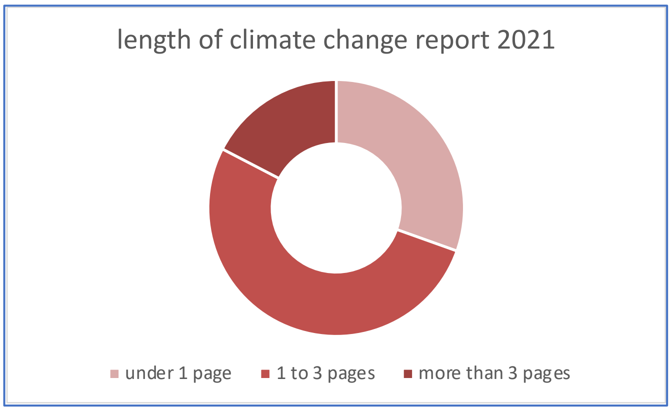
In 2019 PRA issued Supervisory Statement SS3/19[8], on managing the financial risks from climate change. That, and a subsequent Dear CEO letter in summer 2020[9], set out PRA's expectations for how banks and insurance companies should embed the risk management of climate change into their business. During the same period, FCA and HM Treasury has issued various rules and requirements for firms as well, and AFM has tracked those for members, including through guidance issued in late 2021.

The culmination of those various documents was that by the end of 2021, insurers should have established a governance structure, strategy/ risk managed approach, a basis for testing future scenarios, and to have begun to provide disclosure information. This chapter explores progress so far.

How did members report on climate change in their 2021 annual accounts?

All AFM members, including the smallest ones, provided an account of how they were managing the financial risks of climate change: though for some, the report was very limited.

The length of coverage in the report and accounts varied considerably, and for some organisations, a short overview in the accounts was accompanied by a much wider report on their website: Scottish Friendly's sustainability report[10] and The Oddfellows' climate change journey[11] are good examples of this.



A recent FCA review of listed company disclosures[12] indicated the average report for regulated firms was 15 pages, and 80% of disclosures were in the Strategic Report. There was less consistency in AFM members, on the placing of the climate change report, or how well it stood out:

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8 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2019/ss319
9 https://www.bankofengland.co.uk/prudential-regulation/letter/2020/managing-the-financial-risks-from-climate-change
10 https://www.scottishfriendly.co.uk/files/7916/5105/9614/Sustainability_report.pdf
11 https://www.oddfellows.co.uk/media/3359/the-oddfellows-climate-change-disclosures-year-end-31-december-2021.pdf
12 https://www.fca.org.uk/publications/multi-firm-reviews/tcfd-aligned-disclosures-premium-listed-commercial-companies

- more prominent reports were included in the Strategic Report, though some organisations placed their account in the Risk area, or Corporate Governance report, and some included it in a dedicated CSR or ESG section;
- reports with a clear heading and signposting from the contents page were easiest to find, though less ambitious reports tended to have no standout heading;
- Only one organisation, National Friendly, appear to have included their climate change report within the remit of their external audit.

Commitments to net zero

Given the Government's commitment to achieving net zero in the UK by 2050, some organisations wished to set out their own ambitions. 22% of organisations made an explicit commitment to make their overall business net-zero by 2050. 27% of organisations also asserted their intention to make their operations net-zero by 2030 or earlier, and a small number highlighted that they were offsetting now to achieve carbon neutrality in 2021.

Examples of action proposed or taken

All but one organisation offered some kind of example of the action it was taking or proposed on managing climate change risk. Where this wasn't covered in a climate change disclosure, it was implied in other parts of the report and accounts. Not surprisingly therefore, there was significant variation in the actions proposed, as the table below shows, which captures all references found regardless of whether they were in a climate change report.

Activity	Action	*Example or explanation*	What proportion of reports referenced
Operational	Increase energy efficiency	*Also includes use only of green energy*	55%
	Recycling and use of sustainable products	*Such as banning single use plastics*	41%
	Reduced use of paper and waste	*And moving to sustainable print options*	64%
	Business travel	*Includes fleet and working from home*	36%
	Reducing use of water	*Within the business*	5%
Investment portfolio	Manager's strategy	*Working together to develop strategy*	73%
	Manager's reporting	*Securing the information needed to inform decisions*	45%
	Manager's voting	*Setting out expectations on issues to vote on*	5%
	Property portfolio	*Insulation or other action on rental estate*	18%

Products	Changes to own products	*Including new products or funds, and changes*	41%

How well did the climate change report adopt a TCFD-style format?

The Taskforce on Climate-Related Financial Disclosures (TCFD)[13] provides a globally-recognised good practice structure for reporting on climate change risk. In the UK, TCFD reporting is now mandatory for listed companies. Whilst that hasn't been extended to mutual organisations, many have adopted the approach, as it effectively covers the four actions expected by PRA. The TCFD methodology rests on four key pillars:

A small number of organisations made a concerted effort to adopt the TCFD methodology (18%), though none was able in 2021 to complete all elements, with the challenges of reporting reliable metrics the main shortfall. It was also evident that data from asset managers is incomplete, and that currently organisations are not setting high ESG standards on managers, which inevitably compromises their own progress on climate change and social impact.

The following table explores how members' disclosures compared to the recommendations made by TCFD. The observations relate to positive examples rather than the generality of comments made in report and accounts.

Thematic area	Good practice disclosure	Observations
Governance	• Describe the Board's oversight	There were some thorough descriptions of the Board's responsibilities, and how these are supported.
	• Management's role in assessing risks	The clearest disclosure sited the name as well as the role with lead responsibility; for example, Sheffield Mutual sets out the range of actions and training facilitated by the COO, whilst Cornish Mutual has established a Climate Change Strategy group

13 https://www.fsb-tcfd.org/

Strategy	• Describe climate-related risks identified • Impact of risks on business and financial plans	Responses looked at physical and transition risks, in linking their climate work to their overall strategy, and in the case of MDDUS, to their members. National Friendly's focus is on scope 1 and 2 emissions, whilst Benenden identifies the three main SDGs it is focused on, and highlights priorities of reducing impact and improving diversity. Foresters Friendly and Healthy Investment are PRI signatories as part of their approach. Amongst those that focused on their investments, Veterinary Defence talked about a 'climate-tilted change to their investment portfolio'.
	• How resilient is the strategy to different scenarios?	Where resilience was covered, this included continuity plans, eg for flooding. Shepherds Friendly highlighted the importance of the society's values, as well as employee engagement and targeting. OneFamily and Transport Friendly described their use of scenario analysis and the outcomes of this work.
Risk Management	• Processes for identifying/ assessing risks • Process for managing climate risk • How are these integrated into full risk management approach?	A number of firms identified their risk approach, including Cornish Mutual that lists 19 specific risks over different time horizons, and how they are monitored. National Friendly and Railway Enginemen's described how their ORSA and other Solvency 2 tools had been updated to reflect climate risks.
Metrics and Targets	• Metrics used to assess risks/ opportunities • Set out Scope 1, Scope 2, and if possible, Scope 3 emissions • Targets used, and performance against targets	A complete report would describe the baseline position (eg actuals in 2020), the target being aimed for, and what was actually achieved, for each of Scope 1/2/3. It was evident though that this is not yet completely achievable. Benenden, MDDUS, OneFamily and The Oddfellows provided fuller accounts, such as a baseline and emission levels for Scope 1-3 for 2021, and included a detailed methodology.

Actions to consider

- There is likely to be much closer scrutiny of climate change reporting in the 2022 year-end accounts. Whilst the standards expected of small businesses are lighter, all AFM members should include a transparent and meaningful account of what they are doing.
- Use examples from across the business to evidence the outcomes achieved, in addition to the actions taken.
- Review the examples of TCFD-style reporting included in this report to consider what to report on and what your baseline/ targets/ measures are.

5. An assessment of how the sector is adopting its report and accounts as a basis for describing its social impact

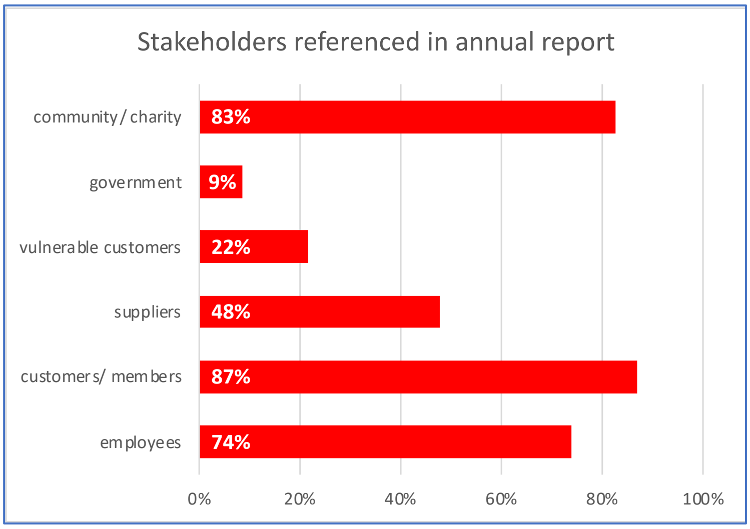
Currently there is no specific regulatory or legislative imperative to report on social impact. However, ESG (environmental, social and governance) considerations, are soon to be the subject of a sourcebook by FCA. Already, where social impact work measures the effect an organisation has on a range of stakeholders, it is a natural fit with the stakeholder focus within principle 6 of the AFM Code.

In addition, for AFM members, many of the ESG webinars and roundtables we delivered in 2021 and 2022 have recognised that customer-owned and not-for-profit businesses have a distinctive business model which means that, whilst they may be relatively small and more limited in their capacity to make significant and meaningful commitments on climate change (the E in ESG), the natural affinity they have with consumers and charities offers a profound opportunity to excel in their delivery of the S in ESG. Currently though there is not a rounded assessment of social impact.

This chapter looks at examples from our review of report and accounts, of how firms are describing their commitment to a range of stakeholders.

<u>Which stakeholders matter?</u>

Looking across members' report and accounts, we found that support for the following stakeholders was referenced:



Not surprisingly, customers/ members scored highest, though it is perhaps surprising that in 13% of accounts reviewed, there was no description of how the organisation supported its customers/ members (note that these were all non-directives). More surprising, given the focus of the sector on supporting the needy, as well as the imminent advent of FCA's Consumer Duty, only a quarter of those describing how they support the needs of customers set out their specific focus on vulnerable customers.

Examples of effective disclosures

Most organisations that commented explicitly on their social impact and/ or support for stakeholders began by setting out how this was consistent with the business purpose, and their values. Setting aside those organisations that included notes on their treatment of stakeholders as part of their response to principle 6 of the AFM Code, a range of organisations made clearer and dedicated statements, covering some or all stakeholders.

- *Employees*: In its dedicated stakeholders' section, The Exeter included a worthwhile range of employee metrics to evidence its approach; some organisations highlighted their inclusion in 'best places to work' tables.

- *Members/ customers*: Benenden included a three-page report on member engagement, and linked this to planned changes to its constitution. Cornish Mutual describes its 'market-leading member experiences', and Scottish Friendly described their creation of a 'fair member benefits' committee.

- *Vulnerable customers*: The Exeter sets out clearly its commitment to vulnerable customers, and it and Sheffield Mutual were amongst the first insurers to sign up to the Vulnerable Customers Charter[14]. The OneFamily accounts set out the specific actions it is taking to support the needs of young vulnerable people.

- *Suppliers*: Railway Enginemen's report included a statement on suppliers it works with and how they monitor contracts. Other mentions included: modern slavery policy (Benenden); new procurement process (MDDUS); outsourcing policy (National Friendly).

- *Government*: MDDUS and OneFamily both cited the engagement they had with government or officials in 2021, and how this achieved better outcomes for members.

- *Community and charity*: Many organisations set out how they engaged with the relevant local community, or the affinity groups they serve. Sovereign Health Care provided £500,000 in charitable donations, and Benenden gave £250,000 to support Ukraine. Cornish Mutual provided a good range of examples of its community support in a CSR report in its accounts. OneFamily has increased the number of days paid leave for employees to support local projects, from one to three.

Two notable publications from AFM members outside their annual report are:

- Scottish Friendly has produced a 10-page social impact statement[15] on their website, providing extensive information on its approach, including a calendar of monthly initiatives in 2021;
- OneFamily has launched its latest 'inspiring better futures' annual report[16], which provides a colourful and thorough description of its support for communities.

[14] https://www.fvtaskforce.com/the-charter
[15] https://www.scottishfriendly.co.uk/files/2616/5105/9614/Social_impact_report.pdf
[16] http://www.onefamily.com/assets/consumer/downloads/company-information/inspiring-better-futures-annual-report-2021.pdf

Looking towards a wider commitment to describing our social impact

The report and accounts of AFM members often include a treasure trove of information on how that organisation supports a wider range of stakeholders, as well as how it makes an impact on society. In most cases however that is not clearly labelled or set out, and the information therefore loses impact. Most reports focus on inputs, such as customer or employee satisfaction surveys, but lack evidence of what action has been taken as a result.

AFM is keen to explore with members how more rigour is attached to social impact reporting in the sector, as well as how it can effectively be measured. Working with AFM Associate member Fidelity, we are exploring a basis for measuring social impact which, in a similar way to Scope 1-3 greenhouse gas emissions, provide three levels of assessing social impact:

- The social impact from an organisation's direct operations and production.
    - This might include the treatment of employees, resilience against cyber risks, the impact on the community, or the ethics of the business.
- Social impact achieved from the activities of its enablers, such as suppliers and distributors.
    - Including the management approach of those enablers, or the potential for negative social impacts from them.
- Social impact at the point of consumption.
    - This might include the fair value of products, data privacy, marketing, and action to avoid mis-selling, as well as the contribution to supporting the basic needs of the vulnerable.

This approach will also support and inform the '*governing body report*', to be produced for approval by the Board at least annually, from 12 months after implementation, that is a requirement of the Consumer Duty[17]. It also provides a lens to hold suppliers to account, and explore how asset managers, auditors and other partners reinforce those standards.

Actions to consider

- Use of a structured approach to social impact reporting in accounts will make them more engaging for members, and support organisations' broader ESG credentials.
- Considering what impact you have on each of your key stakeholders includes setting out the actions you are taking and providing evidence of their effectiveness.
- Social impact is broader than stakeholder management, and should recognise that activities like data security, cyber management and the ESG performance of suppliers affect the reputation and social credentials of the organisation.

[17] https://www.fca.org.uk/publication/policy/ps22-9.pdf

6. A review of board remuneration in 2021

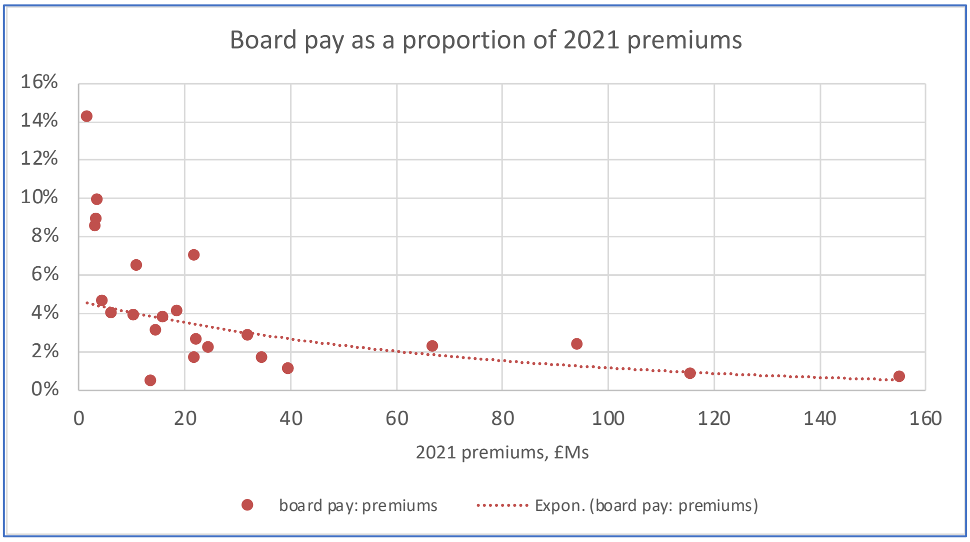
Within the report and accounts, AFM members will set out arrangements for executive pay, as well as for the wider Board. Our review of accounts found that most members are quite transparent about this, and most also seek approval for pay arrangements via an advisory vote at the AGM.

The report and accounts may also set out the basis for executive bonuses, as well as the amount. This is often linked to key results for the business. For example, Sheffield Mutual has modified its executive bonus arrangements, to take account of the society's climate impact, in addition to its business performance.

As we have done for many years, we used our data survey to collect data on board remuneration that members can use for benchmarking.

Total board remuneration

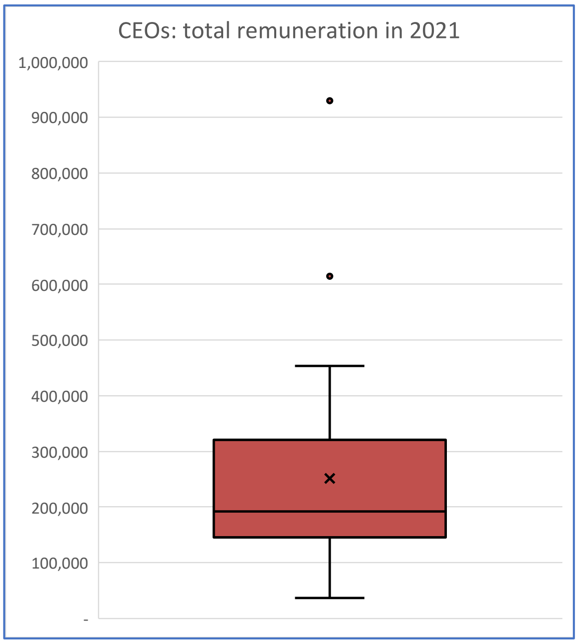
Mutuals will be cautious about overspending on pay, and historically have been alert to accusations that high levels of pay reduce benefits available to members. The chart below tracks Board pay as a proportion of total premiums in 2021. By ranking organisations according to size, and adding a trend line it can be seen that whilst larger organisations might remunerate more in aggregate, as a proportion of premiums, the amount falls away in a relatively linear way.



There is greater divergence from the trendline within smaller businesses, where high costs might be evidence of strategic intent to grow the business, a result of recent recruitment activity, or short-term changes in the business.

The median level of board pay was just over 3% of premiums overall; for investment-based organisations the average was around half that of the rate for health, protection and general insurance providers.

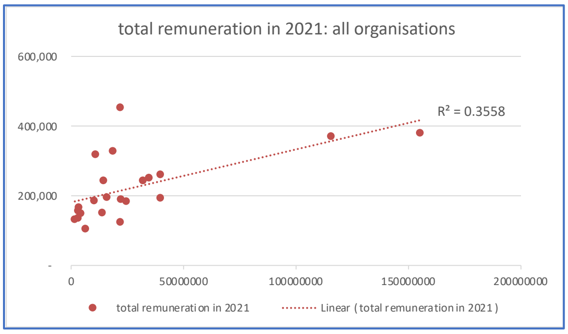
<u>CEO remuneration</u>



The mean total remuneration in 2021 was £252,130. This is illustrated in the chart, and excludes the two outliers with pay significantly greater that the general range (shown as the two horizontal bars). The total pay is significantly greater than the equivalent for 2020 of £197,000.

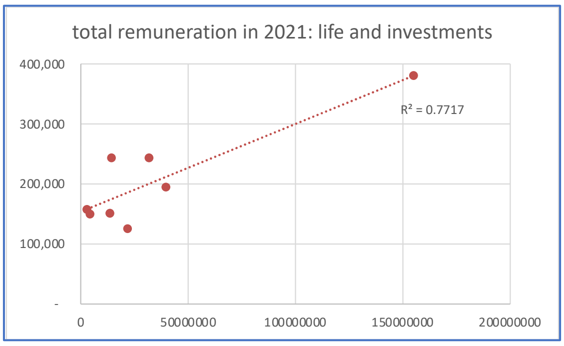
Average base pay was £181,000, with a further pension contribution of £11,000. Two-thirds of CEOs received a bonus in 2021, and for those that did, the average was £50,000. 'Other benefits', such as car allowances, in 2021 were £10,000 on average. Non-fixed remuneration as a proportion of total pay rose from 7% in 2020, to 20% in the year.

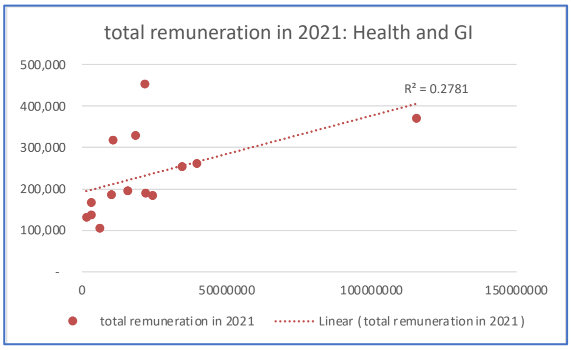
Whilst the diminishing effects of Covid and better prospects in 2021 explained most of these changes, the results are also affected by year-on-year changes in the sample. On a like-for-like basis, the total pay of CEOs where we had a response in 2020 and 2021 increased by 9%, to £218,500.



When we looked at the correlation between CEO pay and premiums (excluding outliers), in general the two go up in unison. However, as the trendline in the chart shows, there is a good, but not a perfect fit.

The correlation is stronger for life and investments than it is for health, protection and general insurance providers, as can be seen in the two sub-sector charts below. This is surprising, given that for an investment-based insurer, much more of the value of the business is derived from long-term assets, whilst for a health, protection or general insurer provider, current premiums might be expected to be a closer match to business value.

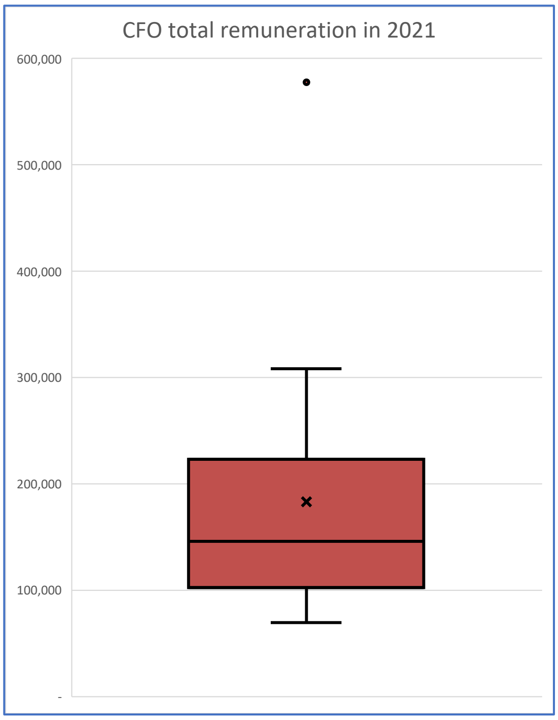


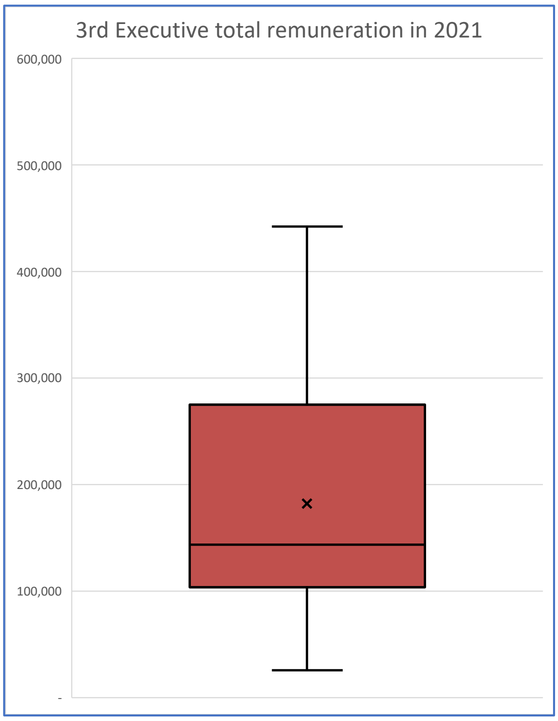


The 9% increase for CEOs in our sample appears consistent with the growth in the sector during the year, and compares modestly with the 39% increase in pay for CEOs of the largest listed companies, according to a report from the High Pay Centre and TUC[18]. That same report indicated the ratio of CEO pay to the median full-time worker was to 109 for FTSE-listed companies, whilst our research on CEO pay, combined with gender pay gap data (see section 7), provided a multiple of 8.1[19].

Other Executives

We collected further data on CFO pay, and for one further Executive. Within small organisations there may be fewer than three executives and/ or the person with responsibility for finance might have a broader job description, but the responses proved to be a reasonable fit.





The mean average total remuneration for CFOs was £183,000, with a median of £145,500. This excludes one outlier, as seen in the chart, and is drawn from 20 CFO roles. The average total remuneration for the third Executive was very similar: £182,000, with a median of £143,500; there were no outliers and the sample size was 13.

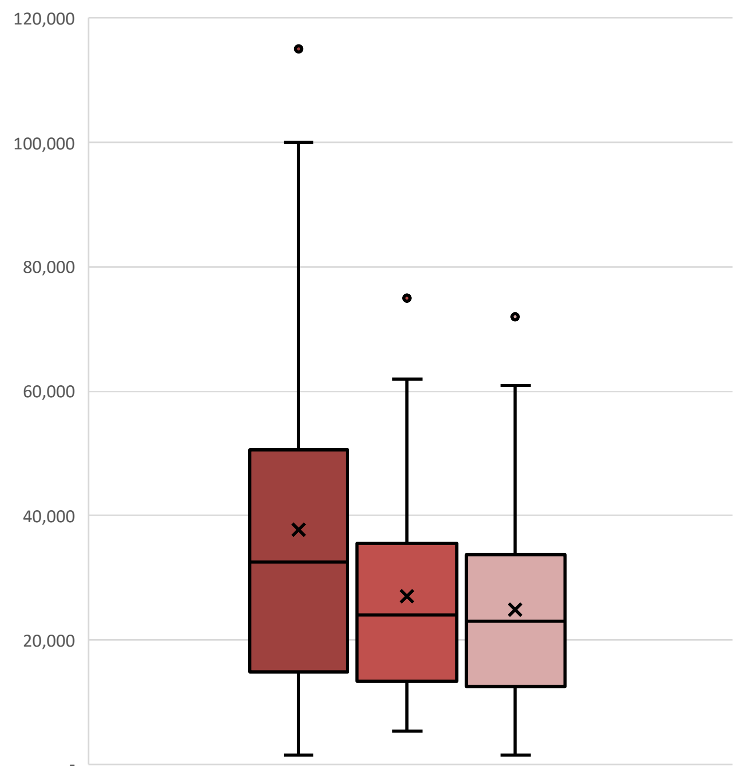
For CFOs, the comparable average in 2020 was around £178,000, though again the sample sizes were quite different and little can be read into the difference.

18 https://highpaycentre.org/ceo-pay-survey-2022-ceo-pay-surges-39/
19 Data is derived from 16 organisations that provided full data.

Chairs and NEDs

We also asked members for data on NED pay, including the Chair. In the past, many NEDs were only paid attendance fees, though increasing professionalism on Boards, and higher demands on Directors have largely changed this practice, especially for firms in the scope of Solvency 2.

The average Chair's remuneration in 2021 was £38,000, excluding one outlier at the high end, and two organisations where the Chair is unpaid. For the Senior Independent Director (SID) and the third highest paid NED the remuneration was £27,000 and £25,000 respectively (again with one outlier excluded as well as any organisations with no paid NEDs).



Chair, SID and other NED remuneration in 2021

The range of Chair's pay was significantly greater than for other NEDs: from £1,500 to over £100,000. Last year we reported mean remuneration for the Chair of £33,000 and FTI Consulting in their report commented there had been very limited change in recent years. The 2021 pay level, notwithstanding a change in the sample, suggests that the pay of Chairs has been readjusted up.

The uplift of Chair's pay relative to the SIDs was 40%, the same as we recorded in 2020, indicating they also enjoyed more pay.

Those changes mean that the differential between CEO and Chair remuneration narrowed in 2021 compared to the previous two years.

CEO: Chair	2019	2020	2021
Mean multiple	7.8	7.4	6.9
Median multiple	6.8	6.3	5.5
Firms considered	16	16	24

Future pay considerations

Our survey also sought feedback on how base pay had increased in 2022 compared to 2021. Most awards were made before the war in Ukraine, rising inflation, and the cost-of-living crisis, and the average increase for CEOs was 3.5%. This compares with a 1.5% rise in 2021, and 3.5% in 2020. With the exception of organisations that had restructured or appointed a new CEO in late 2021, over 90% of CEOs received a pay increase, compared to 70% in 2021.

For CFOs and other Executives it was more difficult to decipher a trend: the average increase was 1%, but changes in personnel and changes in job content meant this was not a reliable guide. With regards to Board remuneration, the typical increase granted for 2022 was around 3%, but this ranged from numerous organisations not increasing NED pay, to some agreeing rewards of 20%, where a structural change or external benchmarking prompted a review.

A recent letter from FCA[20] to larger organisations set out a range of factors that should be considered in setting future remuneration policy: the list is just as relevant to AFM members, and covers: culture and accountability; the Consumer Duty; the rising cost of living (and its impact on employees); operational resilience; ESG; and diversity and inclusion.

Actions to consider

- Linking remuneration to business performance is well-understood, but in today's market the wider impact of the business should be factored into bonus plans.
- Pay awards in 2022 look modest now compared to inflation, though the rising cost of living is also affecting the potential of some businesses to maintain significant board costs.
- SMCR and other regulatory expectations may continue to put pressure on firms to raise NED remuneration, and to close the gap between CEO and Chair.

[20] https://www.fca.org.uk/publication/correspondence/dear-chair-remuneration-committee-2022.pdf

7. A high-level overview of diversity in the sector, including the gender pay gap

The government and regulators have intensified focus on diversity and inclusion in financial services in the last few years, driven in part by consumer sentiment and the political landscape, as well as a general sense of fairness.

AFM's member organisations represent between them around seven million policyholders, and over 2,000 employees. Having a sense of how well the sector is acting, to make products assessable to all, is important, particularly when you're owned by your customers.

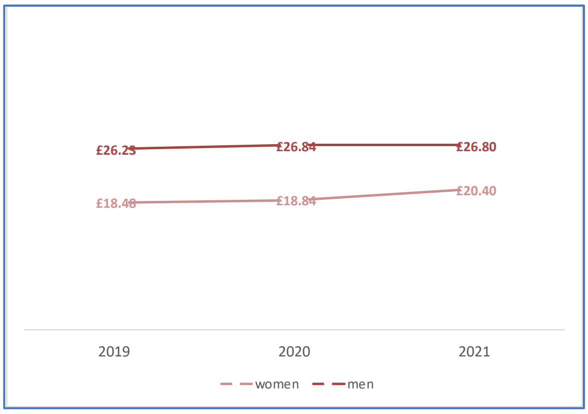
<u>DEI in the report and accounts</u>

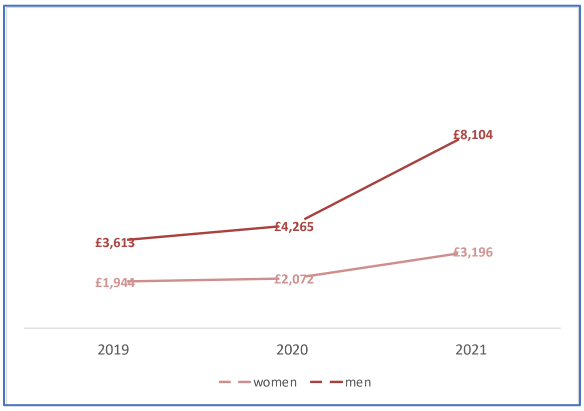
With the global focus on diversity and inclusion, it was surprising that only one quarter of AFM members' report and accounts in our sample included a section dedicated to D&I of at least half a page. Amongst those that didn't have a more dedicated focus, many mentioned the diversity of their Board or the need to address shortcomings in its current composition.

Many of those reporting provided an overview of their commitments, including to the sector's Mutual Diversity Alliance. The Oddfellows provided an overview of the actions taken by the working group it had established. The most extensive reporting was by The Exeter, with a number of sections dedicated to gender diversity, and an explanation of their commitments, whilst OneFamily provided the widest overview of initiatives covering many dimensions of diversity, equity and inclusion (DEI). Cornish Mutual and MDDUS provided specific gender pay gap results, and The Exeter supplied relevant charts.

<u>Gender pay gap</u>

AFM's data survey included a section on the gender pay gap. Nearly all AFM members fall below the 250-employee threshold for formal reporting, so our reporting on this section is in aggregate only. This year, 18 members voluntarily supplied data; this is a little higher than for 2019 and 2020, so direct comparisons and trends may not apply, as the samples are different.

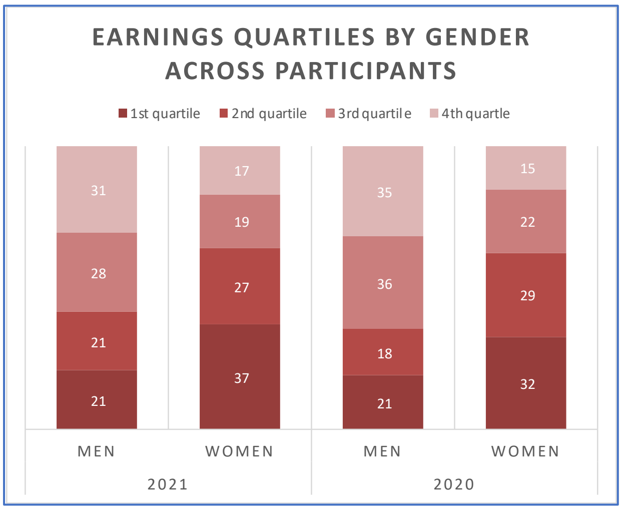




Across the 18 organisations, the employee count was just under 2,000, with 57% female and 43% male. In our analysis, we have taken a weighted average, to allow for different sizes of organisation. Bonuses increased sharply in 2021 compared to 2020, in part due to the decision by some executives to forego bonuses in the first stages of the pandemic. This may account for the greater increase for men in the two years.

Across all organisations that supplied data, 73% of female employees were paid a bonus in 2021, compared to 71% of male employees. However, the sector is not one with a large bonus culture: 78% of organisations paid a bonus to staff in 2021, and the total spent by organisations in our sample on staff bonuses was under £3 million.

The average pay rate for women in the sample was 24% less than for men, though this compares to a gap of 30% in 2020. This does not indicate that women are paid less for the same role, but instead that proportionately more men are in the highest paid roles, as can be seen in the next chart.



The chart shows the percentage of females and males in each earnings quartile across the 18 participants.

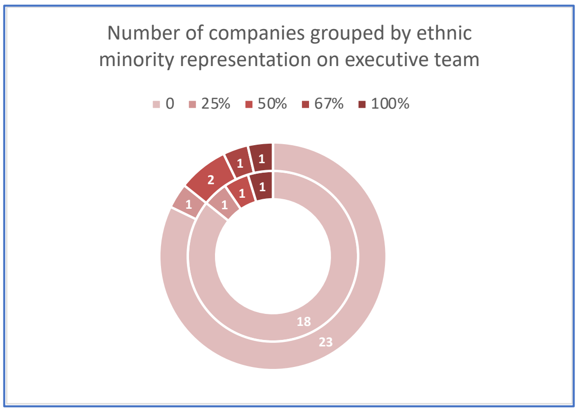
The chart shows an increase of women amongst the top 25% of earners (from 15% in 2020, to 17%), but also that women are disproportionately likely to fall into the bottom quartile, i.e. the lowest 25% of earners.

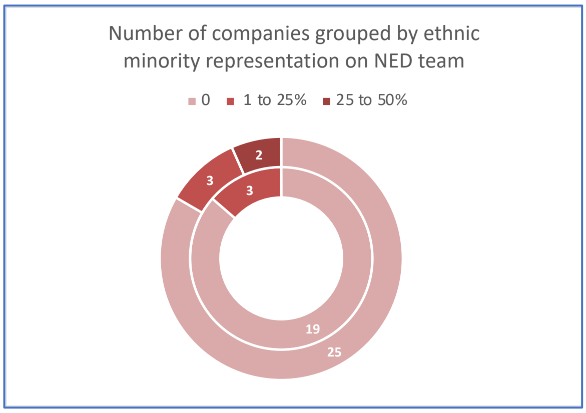
Collectively the charts show progress in some areas, but with more to do.

Board diversity

In a previous section, we set out gender diversity seen on Boards. To complete the picture, we also collected data on ethnic diversity, as well as board members with a disability or long-standing impairment.

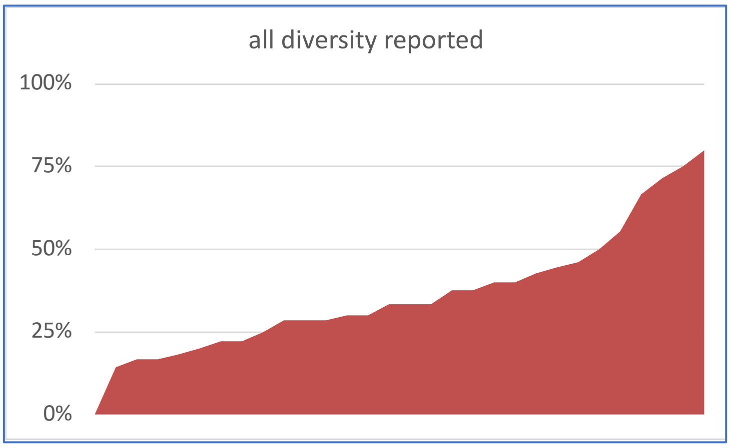
The following charts show the position for 2021 (outer ring), compared to 2020 (inner ring), for ethnic minorities represented in the executive team, and amongst NEDs. This shows an increase in the reported data, and in total, 10% of Executives and 4% of NEDs were from an ethnic minority in 2021 (10% and 2% respectively in 2020).





Eight individual Directors were reported as having a disability or long-standing impairment (4 Executives and 4 NEDs), compared to one in 2020. Whether this represents an increase in numbers or an improvement in reporting isn't clear, but it is certainly a positive step.

Taking all elements of diversity measured, including gender, ethnic minority, and disability, across the sample organisations, 38% of Board members recorded one or more element of diversity (though there will almost certainly be some overlap).



As the chart shows, whilst one organisation demonstrates none of these three measures of diversity on its Board, the range is up to 80%.

<u>Customers</u>

It was not apparent from a review of report and accounts what action most AFM members are taking to remove barriers to access for DEI customers. For member-owned businesses, very often supporting the needs of the lower paid, the young and the elderly, this is a surprising omission. This may reflect the absence of regulatory expectations in this area, though we might hope that in future, as part of a description of its approach to ESG, mutuals are inspired to take the initiative.

The Exeter, Foresters Friendly, MDDUS, OneFamily and The Oddfellows all included reference to the support they give to vulnerable customers. With the FCA's new Consumer Duty coming into force in 2023, it is to be hoped that all mutuals gather more evidence of the work they are doing to support vulnerability.

Mutual Diversity Alliance

The MDA was launched in 2021 to support members of AFM and their work on diversity and inclusion. There are currently 20 signatories, and from September 2022 they will be reporting on their website on the activities they are undertaking to support diversity in the business, the workforce, and their customers. These reports will no doubt provide valuable reference material for future report and accounts. For more about MDA, and to view AFM's first MDA report, see the page on the AFM website[21].

Actions to consider

- Member-owned businesses should clearly set out their approach to diversity and inclusion, both at a board and workforce level. And ensuring it does not create barriers to access to customers is equally vital.
- The gender pay gap appears to be narrowing slightly, in terms of base pay but not necessarily in determining who gets a bonus and how much.
- Board diversity is improving in the sector, with marked increases in the number of directors with disabilities and from ethnic minorities. But having a policy that indicates the business always choses the best candidate available does not take account of whether the selection process itself introduces bias.

[21] https://www.financialmutuals.org/events-training/mutual-diversity-alliance/

Conclusions

This was an ambitious report, seeking to incorporate a vast range of information about AFM members, and draw coherent conclusions. The seven areas covered in the report cover much more than corporate governance or corporate reporting, and rely heavily on the data provided by member surveys, as well as our interpretation of published information. We have not sought to correct or verify data submitted, beyond that which is evidently wrong.

This review has demonstrated the significant work that goes into corporate governance in AFM members, as well as in producing the report and accounts. The pride organisations take in ensuring the report is thorough and compliant is very evident. As the report and accounts broaden again, to incorporate more information about an organisation's approach to climate change, as well as its social impact, it is a very good time to review the progress made, look for areas for improvement, and draw on the considerable good practice in the sector.

The regulatory requirements have continuously added length to the report and accounts, and the challenge for a mutual organisation is very often in exploring how standards that have been predominantly set for listed companies, can be effectively translated into the mutual context. Some firms are doing that with inordinate skill; for others some of the questions to ask in seeking continuous improvement include:

- Consider how readable the report and accounts is to your key stakeholders: will it help members understand how the business is run to achieve good outcomes for them, and will it reassure employees that it is a great place to work?
- How well does the report and accounts use stand-out items, like a key results page, images and charts, and regular headings, to ensure important items are easy to locate and likely to be read?
- What data do you have on readership of the report and accounts as well as its costs of production, and how is this used to ensure any enhancements are proportionate and relevant to your business?
- There is an obvious inverse correlation between board longevity and board diversity, and growing evidence of a direct correlation between board diversity and performance: how well does the maths work in your business?
- As board remuneration increases, how clearly can you articulate the added value you are generating in your business?
- Does a member-owned business have a greater responsibility to set out the positive outcomes it is achieving for a wide range of stakeholders, and its wider social impact? If so, should their commitment to vulnerable customers be more prominent?
- What more information do you need in order to produce a more effective climate change report in your 2022 accounts? What aspect of the TCFD-format should be incorporated, and what ESG standards do you hold asset managers and other suppliers to?

Martin Shaw, AFM, September 2022

Appendix 1: The AFM Corporate Governance Code

The AFM Corporate Governance Code (the Code) was issued in January 2019, following consultation across members and other stakeholders. The Code consciously seeks to help members adopt good practice in corporate governance, and in so doing, reflects the requirements in the PRA's Board Responsibilities supervisory statement (SS5/16)[22].

The Code also takes into account the equivalent code for listed companies, the Financial Reporting Council's UK Corporate Governance Code, though with a view to accommodating the different ownership structure within AFM members. We also reviewed carefully the format of the Wates' Code for privately owned companies, and concluded that the 'apply and explain' model adopted there and in some other overseas jurisdictions, was a more relevant basis for a mutual to set out to its members how the board secures their best interests.

The AFM Code is not a condition of membership of AFM: we recognise there are a range of ways of demonstrating high standards of corporate governance, and the differing peer groups our members seek to be compared against. However, most AFM members have adopted the Code, and as a result, the corporate governance report they publish within their annual accounts provides an overview of whether and how they have applied the six principles within the Code:

1. PURPOSE AND LEADERSHIP	An effective board promotes the purpose of an organisation, and ensures that its values, strategy and culture align with that purpose.
2. BOARD 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.
3. DIRECTORS 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.
4. OPPORTUNITY AND RISK	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.
5. 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.
6. STAKEHOLDER RELATIONS AND ENGAGEMENT	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.

For more information, visit the governance section on the AFM website[23].

Note that FRC plans to consult on changes to the UK Corporate Governance Code in early 2023, and AFM will consider whether and how the AFM Code should be revised to ensure it continues to reflect good practice.

[22] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2018/ss516update.pdf?la=en&hash=9FA09D82A6431745BBA95B3943C9AD13A5FB40A7
[23] https://www.financialmutuals.org/governance/

Appendix 2: About this report

The main sources of information for this report were members' report and accounts. The activity was undertaken in July and August 2022, based on report and accounts publicly available by 5 August 2022.

The report therefore excludes AFM members who had not published their 2021 report and accounts by that time: there may be various reasons for this, albeit regulatory data will have been sent to PRA/ FCA within six months of the year end.

Overseas based members, and a number of AFM's smallest members were also excluded, where it may not currently be proportionate for them to complete a full account of their business and, given the focus is on sharing good practice, where the information produced did not provide any wider value.

The organisations included across all or most aspects of the review were:

Benenden Health
Cirencester Friendly
Compass Friendly
Cornish Mutual
Exeter Friendly
Foresters Friendly
Healthy Investment
Holloway Friendly
Lady Grovers
MDDUS
MDU, The
Metfriendly
National Friendly
OneFamily
Railway Enginemen's
Red Rose Assurance
Scottish Friendly
Sheffield Mutual
Shepherds Friendly
Sovereign Health Care
The Oddfellows
Transport Friendly
Veterinary Defence
Wiltshire Friendly

In addition, AFM members were invited to complete a data survey in May 2022. The results from this survey are included in this review, and in total 28 members provided a full or partial response.