Mark Manning
Financial Conduct Authority,
12 Endeavour Square,
London E20 1JN

29 April 2019

Dear Mark,

AFM Response to FCA DP19/1, Building a regulatory framework for effective stewardship

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 consultation; and
   - Explore the benefits of incorporating an understanding of the mutual business model into FCA's assessment of stewardship.

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 £19.6 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. In particular, FCA and PRA are required to analyse whether new rules impose any significantly different consequences for mutual businesses[2] and to take account of corporate diversity[3].

[1] ICMIF, https://www.icmif.org/publications/market-insights/market-insights-uk-2016

[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

4. In the context of this Discussion Paper, the ownership of a mutual by its customers is particularly relevant. This means that ownership is not widely dispersed outside the organisation, and that the interests of owners and customers are aligned (since they are the same people). The model also means that the potential risk- that management focuses on short-term interests- is avoided, since there is no quarterly reporting cycle, no analysts to satisfy, no short-term traders to reassure, and no propensity to extract value in the short-term to the detriment of long-term investors.

5. This partly explains why the market share of mutuals in the UK has doubled since the start of the financial crisis, and why growth of mutuals worldwide was 150% higher than the insurance market as a whole between 2007 and 2015[4]. The same report by ICMIF indicates that even in the US, widely recognised as the home of the shareholder-owned capital structure, member-owned life insurers have continued to grow rapidly and now account for more than one-third of premium income.

6. Back in the UK, at paragraph 4.5, the Discussion Paper cites that households' direct ownership of shares fell dramatically from over 50% in the 1960s, to 12% by 2016. This means that today the UK's listed companies are primarily focused on meeting the expectations of institutional, rather than individual, shareholders. Hence, where according to the 2014 Hunt Review "one in three UK citizens is a member of at least one mutual"[5], the prevailing source of public ownership of companies today is member-owned organisations such as building societies, mutual insurers and co-operatives.

7. We welcome the FCA's work on stewardship, and the focus of the DP on "the investment activity of financial services firms, where this is undertaken for the economic benefit of individuals". We accept the concerns expressed by many stakeholders that there is excessive short-termism across many parts of the investment sector. Hence, there is a valuable role for FCA in exploring options to ensure the interests of asset managers and long-term life insurers are better aligned with the interests of investors and policyholders.

8. In paragraph 2.3 FCA states that poor corporate governance and a lack of shareholder engagement are contributors to "a culture of short-termism and to high-profile company failures". Whilst action has been taken since the financial crisis to ensure more effective stewardship, the Shareholder Rights Directive (SRD2) is a significant step forward.

[4] https://www.icmif.org/publications/global-mutual-market-share/global-mutual-market-share-2015

[5] http://www.mutuo.coop/wp-content/uploads/2014/12/Hunt-Review.pdf

9. In exploring the structures in the UK to enable investors to exercise stewardship with companies, FCA discussed the problem of the separation of ownership (by shareholders) in public companies, and control (by the executive and Board). We were disappointed to see that nowhere in the paper did FCA explore alternative ownership structures: to illustrate, the word 'mutual' does not appear once in the paper. The caricature FCA paints of stewardship is therefore a simplification.

10. This oversight typifies the approach we see in FCA more generally, with little or no understanding of the mutual model, and little appreciation of how mutuality shares some of the same objectives as the regulator: in this context for example, in ensuring the focus of management is on delivering long-term value. Little wonder then that rule-making has made it more difficult for mutuals to thrive in the UK, compared to other parts of the world[6].

11. With regard to stewardship principles, all AFM members outsource investment management so, as per Figure 1, the asset manager is a different organisation to the asset owner. Our members are not signatories of the Stewardship Code on the basis that they are not direct investors. The asset owners' investment strategy is generally set out clearly- in, for example, the PPFM- and this is used to determine the right asset mix, in association with the actuary and the asset manager(s). By contrast, in the majority of large shareholder-owned insurers, asset management is conducted within the same group.

12. In practice, where fund management is outsourced, it is difficult for the asset owner to exercise active oversight over the specific assets in a portfolio, or to actively contribute to stewardship activities. For example, there is still only limited information about ESG risks, though this will grow over time with the wider adoption of the UN Principles for Responsible Investment. Also, compared to the suggestion in Table 1 that "asset owners [and asset managers] conduct appropriate due diligence on proxy advisers' voting recommendations", for small insurers such as those in AFM's membership, this activity is broadly included in the remit of the asset manager.

13. At present we do not consider there are sufficient tools available to small insurers to undertake this role, and it is not clear to what extent this will enhance oversight if the tools were available. However, in AFM's

[6] To illustrate, AFM engaged for nearly 10 years with FCA and its predecessor FSA, to seek an effective solution to Project Chrysalis, relating to the ownership of assets in life mutuals. The current solution is imperfect and continues to affect sentiment towards the sector.

Corporate Governance Code, we do highlight the need for mutuals to run their business in the best interests of customers and members, to ensure their business is run sustainably, and that reporting on environmental, social and governance standards should take account of the priorities of customers and members[7]. We anticipate that this is a proportionate method for improving transparency of smaller mutual insurers, who lack the capacity to take active stewardship positions, and the scale to exert influence, particularly where they are not direct holders of equities.

14. Chapter 6 sets out proposals for new rules for asset owners and asset managers, and in our estimation will have a significant and disproportionate impact on smaller life insurers, particularly mutuals. Whilst the proposals are designed to enhance transparency, we have a concern that they will increase the regulatory burden on firms, extend the length of corporate reporting and, for members of mutuals, make it more difficult to navigate through and interpret the information presented in the report and accounts. The benefits therefore are limited by comparison with the costs.

15. Where our members are not signatories to FRC's Stewardship Code, it is important that FCA rules are proportionate, and work effectively in isolation, without imposing elements of the Stewardship Code where that is not appropriate. FCA rules also need to limit expectations for '*shareholder engagement'* to asset owners that are PLC owned.

16. We would be happy to work with FCA where it considers new expectations for '*member engagement'* are appropriate for mutuals: for example, by assessing which aspects of Table 2 apply fully and how they can be best applied by mutuals. Otherwise the form of framework FCA wishes to build will be distorted and lack credibility. Alternatively, we suggest FCA include a threshold for any rules set, for example, at £2 billion of assets under management, which would exclude small asset owners such as most AFM members.

17. We would welcome the opportunity to discuss further the issues raised by our response.

Yours sincerely,

Martin Shaw
Chief Executive, Association of Financial Mutuals

[7] http://www.financialmutuals.org/files/files/AFM%20corporate%20governance%20code%2C%20jan19(2).pdf