ABSTRACT OF THE DISCUSSION

HELD BY THE FACULTY OF ACTUARIES

Dr D. J. P. Hare, F.F.A. (introducing the paper)**:** In October 2000 Mr David Kingston delivered his Presidential Address. 'A Learning Profession' was a wide-ranging and inspiring talk, touching on many issues of importance. To quote the abstract: "This Presidential Address is a call to arms for the profession. It outlines many areas in which we could be major contributors if we are prepared to undertake the necessary research, discussion and seminar work.'' That is where the origins of this paper and meeting lie.

Among the issues affecting the profession which the President touched upon was the management of life insurance companies, both as independent entities and as parts of wider conglomerates. Drawing on his experiences with Irish Life, both before and after its demutualisation, and put in the context of developments in various countries and comments made by Mr Malcolm Murray in his Presidential Address, Mr Kingston emphasised the particular issue of mutuality and asked:

> "What have we as a profession to say on these matters? While they may not be matters which require guidance notes, they are still of profound importance both to our profession and to the wider community. I would like to see the profession doing some work on possible structures, which would combine the best elements of mutuality (which, in my view, revolve around the capacity to take a long term view) with the best elements of shareholder ownership (which, again in my view, revolve around the capacity to change and raise new capital)? It seems to me to be a great pity if, with a few notable exceptions, the only capital structure available to policyholders is via a quoted company.''

He then went on to encourage actuaries to look to the future and any reversal of the present swing to free markets and to a 'shareholder society', and see what we, as a profession, could say on forms of company ownership.

Having worked within both mutual and shareholder environments, I expressed an interest in what might be the outcome, as did Mr Brendan McBride, and so it was that, some months later, we found ourselves meeting with Mr Guijarro (who had previously volunteered for a Faculty Research Group) to see how we could take the President's challenge forward. It soon became clear that to try and develop new corporate structures might be slightly beyond our resources, not to mention our knowledge and expertise. We decided to lower our sights, and aim to produce a survey paper which could form a useful background to a panel discussion. Our purpose was not to demonstrate that one form of ownership is, by definition, 'better' than another — rather, we wanted to understand the different legal structures which currently exist, and the reasons behind the choice of structure for different companies — especially those which have changed recently.

Mutuality in financial services is certainly not dead, particularly when viewed internationally, although it seems likely that a further reduction in significance is on the way in certain overseas countries. Mutuality still has its supporters though, as is shown by the work of the International Association of Mutual Assurers (AISAM) and other organisations like it, as well as the growth of microfinance. Whether there are any more changes in the United Kingdom remains to be seen — indeed, if organisations like Mutuo have their way, the extent of community ownership could grow considerably — and not just in the realms of football supporter representation. A not-for-profit replacement for Railtrack has been talked about, as have community-owned utilities companies.

However, what of financial services? Is mutuality fine for small niche players, but something that most companies grow out of, or move out of to grow? If there were no mutuals left, would

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that matter in the meeting of customers' long-term financial needs, or is diversity of corporate ownership important both to individuals and to markets as a whole? Has increased regulation removed one of the historic attractions of mutuality, or is there truth in the argument that mutuals can manage for the long term, whereas proprietary companies can be dogged by short-term considerations? Alternatively, is the opposite the case, and external shareholder scrutiny vital to the long-term stability and health of financial services companies? If so, then what lessons can be drawn from the recent demise of a certain American energy company and the effects that this has had on the investment markets? What has it got to do with the actuarial profession anyway? Are there issues of public interest here, or do the commercial interests of actuaries limit the extent to which the profession can voice opinions in this area?

These are just some of the questions that Mr Guijarro and I pose at the end of the paper, and it is our hope that this discussion does, indeed, prove wide-ranging and enlightening. We were keen to have a panel for this meeting, since, the more we read, the more we realised that much of this ground is already well trod in the literature, and many, academics especially, have forgotten more on some of these issues than we feel we now have learnt! One of the authors whom we came across is our panel chairman, Professor Paul Draper. Given his involvement with Edinburgh University Business School, we thought that his presence here would help to strengthen our existing links with this university through the Profession's University Initiative. However, that was before Paul decided to move to Exeter at the start of this year.

Professor P. Draper (a visitor; panel chairman; University of Exeter)**:** One of the interesting things about the literature on mutuals is that it is basically an evidence-free zone. The amount of empirical work that is relevant and actually comes to a conclusion is remarkably small.

There has been a huge amount of American work on savings and loans, and one can summarise it very quickly by saying that it finds that savings and loans run by mutuals are, on the whole, poor performers, and that those run by joint stock companies are rather better. However, the particular qualities of savings and loans in the United States of America are such that I am not sure that these findings are useful for us.

Once you move on to insurance companies, the academic evidence is thin on the ground. I prefer the view that argues that the market determines structure, and that it is competition that is the underlying, fundamental driver. I participated in some research, looking at the returns on life assurance policies, which found that 'super mutuals' (very large mutuals like Standard Life) seemed to outperform both smaller mutuals and joint stock companies. We looked at the returns on policies over more than 20 years. We also looked at surrender values.

Having seen what has happened to Equitable Life, I would now be more cautious in my conclusions. It is quite clear that it was a small sample and was relatively unique. One must be very careful before drawing any conclusion from the available data.

What I should like to encourage in this discussion are contributions from those who have real, practical experience, because their experience represents case study material, which is particularly important, given that the statistical evidence is fairly weak. It is, perhaps, much more useful to look at what people can contribute in terms of their knowledge of the process. With that in mind, I have suggested that the President might start, because he has had experience both in a mutual and in a joint stock company. Then Mr Hill is going to look at it from an industry perspective, although, perhaps he has a joint stock bias. Mr Snaith will put the other case, and Professor Ricketts will talk about ownership rights. Then I will open it up to the floor for discussion.

The President (Mr T. D. Kingston, F.F.A.)(panel member)**:** Since the authors blame me for starting this debate, you understand that it is one on which I have particular views. The paper is a good review of the historic position of the topic, and it also points to the future. One of the interesting things that I felt, after reading the paper, was how cyclical all of this is. We have been in and out of different forms of ownership over the last couple of hundred years, and that, to some extent, is a reflection of the political and social situation in which we found ourselves. It

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would be a pity that if, in those 200 years, we had not learnt something about the possibility of different forms of ownership and whether those were good or not.

As Professor Draper said, in a sense I have been in and out of different corporate structures. I began work in 1964 in Scottish Widows. It was then a mutual; it is not now. Indeed, all the major Scottish offices were mutuals at that time; the then Association of Scottish Life Offices was an association of a very homogeneous group of companies, nearly all mutuals, all tending to work in the same particular way.

The only exception was Scottish Life, which mutualised in 1967. One recollection which might say something about that period was that, during my time at Scottish Widows, on the day of the AGM, I and some others were called to the staff restaurant where the AGM was being held, in order that the directors would have somebody to look at. It is an indication of the breakdown of communication between the policyholders, as owners, and the company. It seemed a matter of amusement at the time, but, in retrospect, it said something.

I moved to Irish Life in 1968. Irish Life was a government-owned company which attempted to mutualise a couple of years later, in 1970. It did succeed in buying out most of the dividend rights, but the Irish Government refused to give up its voting rights and retained its voting control. It was a semi-mutual in a sense, but with voting control held by the Government. That seemed the best model in 1970. By 1990 things had changed completely. We wanted to expand overseas. Banks were expanding into our business. Traditional distribution was becoming too expensive, and was very much under threat. We needed to have a more flexible capital structure to accommodate this, and government ownership was just about the worst structure, as we had no means of raising capital either from policyholders or the Government. So, in 1991 the company went public, and it remains a quoted public company today, having, in the meantime, merged with a demutualised building society.

I spent seven years there before the company went public, and seven years after as chief executive. The seven years answerable to shareholders were very different from the previous ones. I pick out two differences. First, the 'shareholder' ownership there was far more critical, and there was far greater public and media interest in the company. Up to the point where we went public, by and large the media simply reproduced whatever press releases we put out. That changed afterwards. I think that the main reason why it changed was due to people like Mr Hill; the media did not work any harder, but, after the company had gone public, they could phone up investment analysts, and the investment analysts were very critical reviewers of the company. It was a different situation. For the first time there were people who understood the company, looking at it critically, and their comment then spread into the press and, ultimately, to shareholders. The criticism was largely focused from a shareholder point of view, but, having said that, many of the shareholders were policyholders, so you did tend to get some balance in that regard.

The second difference was a much greater emphasis on short-term performance. Although that has some points in its favour, because you clearly cannot put pressure on the company without putting pressure on the short term, there are undoubtedly some negative aspects, particularly in the need to have steadily growing income to shareholders. Shareholders like to see profits increasing. I suppose that they would like to see profits increasing by 100% a year, but certainly by a nice 15% a year — that is the sort of figure that is set. That is not natural, in a sense, for businesses, which are subject to economic cycles. So, you find yourself, to some extent, doing unnatural things in order for that to take place.

Irish Life was a slightly unusual example, in that the company had stopped writing with-profits business before its capital restructuring, and to this day does not write with-profits business. The issues are definitely different for a with-profits company that demutualises, at least one that is writing with-profits, and there are more difficulties between conflicting interests in that situation.

I now turn to some of the questions which the authors pose in Section 6, and which are the very key to all of this. I do not deal with them in order. First, there is market concentration. There is no doubt that the life insurance market in Europe generally, and in the U.K. in

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particular, is becoming more concentrated. It is interesting that it does not seem to be happening to the same degree in the U.S.A. I believe that the same is true of banks and building societies. This has some desirable effects, particularly in the expense reduction area, for example, but there is a need for innovation in the types of savings products. That might best be served by new companies; it certainly has been in the past, with the growth of unit-linked business, which was largely brought in by new companies. So, we need to make sure that whatever structure we have allows new companies to get going and that there are no significant barriers to new companies, whatever their capital ownership.

Having been on both sides of the fence in proprietary and mutuality situations, I can see the advantages and the disadvantages of different forms of ownership. I am absolutely sure that accountability is a major issue, and that mutuals only deserve to survive and prosper if they are seen to be accountable to their owners in a way that has not always been true, especially for life companies. It has probably been better for building societies. Whether it be an existing mutual or a new one being established, a company would do well to create natural communication and pressure points between its policyholders and itself. It is too late when the Equitable Life situation is reached or when carpetbaggers are at the door.

Diversity of ownership is desirable, with the resultant different pressure points of different organisations and the competitive advantages that some have against others in particular circumstances. It would be a great pity if a single model existed, whatever that model. The Scottish market was very homogeneous in the 1960s; it would be a pity if it goes to the other extreme, and all the companies are joint stock companies. I hope that that will not be the case, and that more than one model will exist, and I hope that we, as a profession, will help that to happen.

Mr R. M. Hill, F.I.A. (panel member)**:** My background is as an insurance analyst, and in my 18 years in that role I have experienced demutualisations on four continents. I have to confess that demutualisation has been one of the best things that has happened to my career. The views that I express are my own, and not necessarily those of my employer.

The question is: "Should we favour corporate diversity?" The answer to that seems pretty obvious: "Yes, diversity promotes competition, spreads risks and provides choice. This is not diversity for diversity's sake, but diversity for a reason: that is value for money, however loosely we define it."

The U.K. insurance industry is experiencing climate change. The Government and the regulators are of the view that the industry is fragmented and inefficient, and that all too often the benefits of competition go to the distributor, rather than to the actual buyer of the product. The pursuit of increased efficiency has seen the demise of a large number of life offices, both mutual and proprietary; size, not status, has been the main issue. For mutuals seeking to gain critical mass, a shareholder structure offers greater flexibility and access to capital. Nevertheless, I have been surprised that we have not seen more mergers of mutuals, as happened in the building society movement in the 1960s and 1970s. For the industry as a whole, there has been limited use of outsourcing as a way of accessing economies of scale, and more could be done in that area.

In response to this increase in competition, we have seen the life industry consolidate, globalise and expand into related areas, such as banking and fund management. However, this has had obvious side effects. Organisations have become more distant from their customers. For mutuals, this often meant that many of their customers were no longer members. Key reasons for several demutualisations were simply that few people were buying with-profits policies and that the owners of the business were moving into the minority. For those that have diversified, there is also the question of what risks with-profits policyholders believe are being undertaken on their behalf.

I argue that mutuals have a place as long as they provide value for money and their customers see benefits in ownership. It is somewhat ironic that the life company that arguably came closest to these goals was Equitable Life. Mutuals are likely to disappear completely unless customers deliberately seek them out or new ones are formed. One of the more interesting areas

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of the paper was in looking at the motives behind those who founded mutuals, building societies and credit unions. They were seeking to fill a need that was either not being met by the market or were entering an area where regulation was ineffective or competition was weak. At the risk of being cynical, it would also seem that mutuality was sometimes chosen as a marketing device; the sponsors had a vested interest in the success of the enterprise, and felt that the absence of shareholders would make the company's products easier to sell.

The regulation of the financial services industry has undergone substantial change, and, assuming that Mr Sandler achieves his objective of making sure that the forces of competition are operating properly, then it seems to me that much of the rationale for forming a new mutual is greatly reduced. Maybe the mutual of the future is just an affinity group!

Gaps in the market are more likely in less sophisticated countries, and hence we are more likely to see new mutuals formed overseas. As the paper points out, where there is a gap in the U.K., it is in respect of low income groups. To a large extent, this is a product of the high cost of regulation, and that failing should be addressed, rather than promoting new structures. Also, one has to be wary of paternalism in that area. Policyholders would get better value from putting their money in a building society than from buying industrial branch type policies. If the concern is the failure to save, then maybe that should be dealt with through the tax system or by compulsory stakeholder pensions. Much is made in the paper of the success of credit unions, but I would ask whether lighter regulation has not caused its own problems there.

I now comment on the suggestion that mutuals should be protected. There is a view that mutuals would be under less pressure to convert if members were not to receive windfalls. This argument misses the point. With one exception, as far as I am aware, all the demutualisations in the U.K. were led by the management, not by the members.

Demutualisations have happened in countries such as the U.S.A. and the Netherlands without any immediate benefit to members. While I have sympathy with mutuals not wishing to have conversion forced upon them, that should not be an excuse for protecting inefficient organisations, and, if windfalls are to go to others than the current members, I would like them to go to a clearly identified good cause rather than to some charitable trust controlled by the management.

So, should the actuarial profession encourage diversity? It should promote better understanding and balanced arguments. There are good arguments for diversity, but that is not an argument for protecting all mutuals.

Does external shareholder scrutiny lead to short-termism? This is a slightly different question, because we seem to be looking at whether this applies to a private or non-quoted company, as opposed to specifically whether it applies to a mutual or proprietary company. I find it difficult to separate those influences. So far as I can understand, that has been the focus of a number of academic works. I thought that the case was very much 'not proven'.

Can anything be done to lessen short-termism? The markets are designed for people to compete, and competition involves management taking risk and innovating. There is always somebody who makes mistakes, people who see a short-term issue as a long-term trend and get it wrong. I do not think that people should be stopped from competing.

Mr I. Snaith (a visitor; panel member)**:** I have two jobs. I am an academic, a Fellow in Law at Leicester University, and I am also a consultant solicitor with a firm which has developed a specialisation in mutual issues and mutuality. I am also the author of a book on industrial and provident societies.

I now cover the questions that lawyers raise, and I emphasise that I am not an actuary and I am not an economist. The first question to be asked is: "What do we mean by 'mutual'?" Perhaps that is more a philosopher's question, but lawyers can perhaps tell you.

One idea of a mutual is mutual trading. That is a very narrow, very specialist idea, and it is quite different from the way in which the word tends to be used. It means that you only trade with your members and you trade with all your members. I suspect that some mutual insurance companies, at some stages, would have met that definition, but I should say that people refer to consumer co-operatives as mutuals, and if they were that, they would have very little trade at all.

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That is a very narrow definition of a mutual, which only some, such as craft unions, would meet.

Another issue is: "Who benefits, what is the point of a mutual?" That concept, in co-operatives, including credit unions, also in mutual insurers and in building societies, would be answered by reference to the members. Very clearly, the members are the people who you are there to serve, but the contrast with the proprietary company is that you serve them as users, in some sense, rather than serving them as investors. That is the key idea.

However, there is another type of mutual, using that word in the wide, and perhaps rather sloppy, way that people do, which is the community benefit mutual. This is a different idea altogether, and is something which is not there to serve its members; it is, in fact, there to serve a different group. The popular common example is housing associations.

These are some definitional points, but they are very important, because, when you start asking about whether you should allow conversions and what happens to the assets at the end of the day, it is important whether the mutual is there to serve the members in one way or another or whether it is actually there to serve a different group, in which case it is more like a charity, and it really ought to say that those assets should be locked in.

In the community benefit form, you are really comparing with a charity, but you are not a charity, because of the narrowness of the objects and the fact that you are running a business rather than simply being a trust, and so on. The idea that my firm has, which has been used for football supporters' groups, and which is the one that has also been mooted, but not used, for utilities such as water companies, and even, it has been suggested, for Railtrack, although that would not appear to be a realistic option, is based on a kind of mix. The very clear base line, in terms of whom it serves, is the community and not the members. It is that kind of mutual, but it has the kind of hybrid aspect that, in terms of its constitution, you invite the users and probably the employees to serve on the board and to be elected to the board. So, you have a mixture. I will come on to why that is crucial. However, of course, there are other issues about that kind of community benefit model: "Do you allow conversion, and so on?"

The more obvious areas for lawyers is the legal structure. Again, this relates to what we have been saying about the basic questions. One legal structure, the Companies Act 1985, usually commonly focuses on the investor. That is normal in companies. The point was made by Mr Hill that that is not always true. If you have a private company, you do not have the disciplines of the market, the public liability company (plc) model. When people talk about the benefits of efficiency of companies, they really mean plcs, and they really mean quoted or listed plcs. It is only there that you have the market with the analysts and the press reporting. In most of the other forms analysts and the press are not involved, and, in particular, there are no institutional investors who might take a particular interest in what is going on. You could use the company for a mutual. The company does not have to be investor led. You could have the company constitution so that it was the users or the employees or somebody else who ran it. The company is just the legal vehicle. You could use it in these other ways.

The legal issue that it seems to me is key, having mentioned the market issue, is the issue of the duties of the members of the board, the issues of what the responsibility of this group is, those who are supposed to be there as stewards or as custodians acting in the interests of other people. In the investor-dominated model, the typical company, that is pretty clear. We know that there is much rhetoric in 'manager speak' about the stakeholders, but when it comes to the legal crunch, the members of the board serve the shareholders. They are the ones who are in the dominant position. The Companies Act says that they have to consider the employees, but the employees have no right to sue if they do not. The shareholders are in a different position. When there is a tough decision and they cannot accommodate everybody's interests, it is the shareholders' interests that they have to pursue. That is essentially the company model, unless they have rewritten the constitution and said that it is somebody else who is in the driving seat, which is not the normal position. The other point to make is that you can make a tailored mutual company, but, of course, companies can always change their own constitutions, so there is no guarantee ever that group members would not do that.

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Another point on legal structure is the rather arcane backwater, as it has been called, of industrial provident societies, my own particular pond that I paddle in, which are governed by separate legislation, the Industrial Provident Societies Acts 1965 to 1978, with a possible new bill in 2002, but it is a private member's bill, so we should not get too carried away. This is a totally different regime, a key feature of which is worth emphasising, and concerns the regulator. This is massively confusing, because since the 1 December 2001 the regulator is the FSA. It regulates everything else, why not these? The answer is bizarre, because it regulates them in the sense that they are registered with the FSA like companies are registered at Companies House, even if they are not financial services bodies at all. So, the local Co-op which sells groceries is registered with the FSA because it is an industrial provident society (IP). The FSA was the only available regulator.

The importance of that (it does not matter who the regulator is) is that, under these Acts, registration is different from that of companies. If you want to register an IP, you have to satisfy the regulator that this is either a co-operative, a bona fide co-operative, not just a false one, or a community benefit society; one or the other, and they are different. If you are a co-operative, then you are there to serve your members, but not like an investor driven company, there to serve its members as users. An example is a group of farmers who sell their produce to the co-operative, so that they can get together and redress the market imbalance against the arguably oligopolistic purchasers. The members are in charge, and they benefit.

The community benefit society is, in a sense, the opposite. It is intended to benefit people who are not members. It is altruistic, and is nearer to being a charity. That is a vital distinction.

Not only does the FSA govern the registration of these organisations, but it also controls any rule amendments. If they want to amend the rules, the FSA has to approve and agree. If it does not, then it does not have any effect. It is done on the same basis as it registers organisations in the first place. They still either have to be a co-op or still be a community benefit society. It is a very different legal model from that of companies.

My firm's idea of the community benefit model is really a kind of hybrid. The FSA is there to police the change, which cannot be done within the structure into something different. It is almost, in terms of the paper, full lock, but it is not quite, because the Act says that you can convert into a company. Is it always possible to convert into a company? Once the IP converts into a company, the regulator has no more power. So, if it was a community benefit society, it could, effectively, be privatised. That seems particularly outrageous, since it was never there to benefit the members in the first place. It is different if it was a co-operative and the same members decided that they would rather benefit as shareholders. This is a key issue, and the law is not entirely clear. There are ways to try and lock in the assets, and these have a decent chance of success.

There is then the idea, and this is perhaps the central one, that the duty of the directors in this model of a community benefit society is to the community, the non-members, it is not to the members. There are representatives of different stakeholders having input, and there is accountability through trying to have people with different areas of expertise, as well as users, on the board. It is a model which is an attempt to get the best of both worlds, if you like, between co-operatives and benefit companies.

What are the lawyer's answers? There are not any clear-cut answers, but just some thoughts. It is interesting to note that there is a structure, the industrial and provident society, that is policed as to its status. The downside is that, if you can convert to a company, then this is undermined. It is absolutely vital, in any debate like this, to understand that there are three alternatives advanced: the benefit of a community, a different group; the benefit of the members as users; and the benefit of members as investors. That threefold point is important, because it would seem that there is a strong argument for locking in the assets if it is a community benefit and analogous with a charity. The arguments are less clear where it is the benefit of the members as users, although they do exist. The argument is that, if you want diversity of enterprise structures, surely it should be a right that people have, if they choose, at least at the beginning, to

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say: "We are choosing it as a structure that cannot be changed by new groups of members." Why should they not have that right? Why should the law not give them that when they set it up? The argument against, of course, is that that makes for inflexibility. Even if you cannot change the structure, you could always sell the entire business to somebody else. It is just that the actual resulting asset is in some sense locked in. That is clearly more controversial.

As a lawyer, my view is that the choice issue is important. You do need to have variety of organisations to be able to choose from. Do not forget that sometimes mutuals are mutuals of businesses — Interflora is a kind of mutual. Florists have got together and have this particular set up for a particular function. In agriculture, also, there are many mutuals of businesses. The key issue of management accountability is a problem, and has not been cracked, but that depends on how effective you think that the stock market is. If you do not think that it is brilliant, then maybe mutuals are not that much worse. Who can say?

The legal structure is something that I do know about, and there is an ignored point which is very important. It does matter which stakeholder group, or whether, indeed, it is no stakeholder, but a different group altogether, that the directors are supposed to be considering when they make decisions. That is crucial. If it is the investors, there may be a different decision at the crunch than if it is the users or some other group, some wider community.

Flexibility is important. The challenge is what I call 'virtual' equity. Are there ways of replicating equity in a mutual that would allow some of the advantages, but would still maintain the concept of the mutual as one person one vote, and so on?

Professor M. Ricketts (a visitor; University of Buckingham; panel member)**:** I am an economist, and not a trained actuary or accountant. My comments will come from a slightly different perspective, although they do follow on in some ways from the comments of Mr Snaith.

Economists are always good at producing theories, and I now make a few comments about what legal economists have come up with as to how ownership rights are assigned. I am particularly impressed with a legal economist called Henry Hansmann, who wrote a book called the *Ownership of Enterprise*, published in 1996 by Harvard University Press. Essentially, he asked: "How do we explain different governance arrangements anyway? Are they just random things that crop up?" We have had in the comments so far a fair number of implicit explanations, but what Hansmann argued is that the firm is just a hub of relationships with its patrons. 'Patron' is used in a general way: it might be a consumer; it might be an investor; it might even be a worker, or a saver or a borrower, of course, in the case of a financial institution — anybody who is transacting, in some sense, through this entity called the firm. Hansmann has simply asked the question: "How would we explain which group or groups would be allocated ownership rights?" Owners, one way or another, are members of a co-operative. If you have many members, the plc can be regarded as an investor's co-op. If all the members are workers, the firm is a worker co-op. If all the members are consumers, then there is a consumer co-op. The point is that ownership rights in these cases are allocated differently. Hansmann asks: "Why is this? What are ownership rights?" Ownership rights presumably confer some right to receive the residual profit from the enterprise, and, probably more fundamental than that, even though the two things are usually held together for obvious reasons, is the right to discipline the managers, the control rights.

The question is: "Why do these ownership rights tend to be allocated to investors rather than to other groups?" Broadly, Hansmann's argument is that transactions are costly, one way or the other, and that costs of transacting vary. He has in mind things like search, negotiation, bargaining and the risk of opportunism, of being 'ripped off'. Of course, you can get round the problem if you own an enterprise, but then you have to monitor your managers and you have to make decisions about what the purposes of the enterprise are, and so on. Hansmann talks broadly about costs of transacting and costs of ownership. These are very vague things, and very difficult, perhaps, to measure empirically. This is where the empirical problem becomes intractable, although I am sure that work will be done on this. An interesting question arising which relates to our topic is: "What, in the end, determines the ownership structure of an

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enterprise?'' His broad conclusion is that ownership will be allocated to the group that faces the highest costs of transacting. If it is costly to transact, then maybe ownership is a substitute. So, why did the Rochdale pioneers own their retail outlets? Because they foresaw themselves facing huge costs of transacting. There was the question of trust in the quality of the product. There were problems of monopoly in those days, so, perhaps ownership would be a good way of getting round the situation. Retail co-operatives were a way of getting over that kind of transactional impediment. So, Hansmann would see consumer ownership as natural where consumers face the highest costs of transacting. They can own the firm, especially if it is not a terribly capital intensive business, and the management is quite routine, etc. We would not, perhaps, expect that to be very common, but it did happen.

It is important that the cost of ownership cannot be too great. One of the things in the co-operative literature which is quite characteristic is that there is often a great deal of idealism associated with mutuals and co-operatives, and one of the interesting parts of the literature is that there is a debate as to why the Rochdale pioneers and those who followed them did not extend ownership rights to workers. They never did. Apparently, although I have not read the economic history, they were encouraged to be more radical. However, Hansmann would say that it is obvious why they did not include workers in the co-operative. It is because that would increase ownership costs tremendously. You have to make decisions. It is decision-making costs that would then become difficult. His basic explanation, therefore, for the dominance of the investor-owned firm is that ownership costs are relatively low, in his view, for an investor-owned operation. Why? Because investors have pretty homogeneous interests. If there are many heterogeneous members, then that increases the costs of decision making tremendously. That is a huge ownership cost to bear, and it is only worthwhile assigning ownership to a group if the costs of ownership do not outweigh any benefits that are got from the fact that it does not have to transact in a rather hazardous environment.

One can see similar forces operating in financial institutions as well. I would think, especially in 19th century conditions, and probably even in 21st century conditions, that transacting in financial markets is fantastically hazardous, or at least potentially so. Therefore, one might think that mutuality is one way to mitigate, if not to solve, this. You never solve these problems, you simply adjust to them; and maybe ownership, that is residual rights and control rights, should be assigned to the membership. The mutual is, broadly speaking, a transactions cost minimising structure.

There are a number of questions at the end of the paper. One can interpret the question: "Is the trend to shareholder ownership a natural progression?'' as meaning: "Is this the result of a competition in the marketplace between institutional forms? Is it, from a transactions cost point of view, now no longer true that the mutual is a suitable structure? Does the decline in mutuality reflect recent changes in transactions and ownership costs?'' My response would be that one would have to look at whether transaction costs for investor-owned companies were falling. I suppose that you could argue that. In the paper, the argument is that the brand is becoming so important. That is another way of saying that transacting with a firm that is not mutual is becoming less hazardous. It is investor owned, and, in your worst dreams, you expect the investors to rush away with your money and go to South America, but, actually, the brand gives you confidence that this is not going to happen. In other words, we have accumulated capital in trust, and it is possible for the market to produce trust over time, and this has enabled non-mutuals to compete effectively with mutuals. It is rather like the change in retailing. In the 19th century the Army and Navy store was a co-operative, a middle-class co-operative, presumably again because of these great transactional hazards that were faced. In the 1860s the middle classes were beginning to buy all sorts of fancy goods that they had never bought before, but, because of their lack of information, they were exploited by retailers, and so on, leading them to set up a middle-class co-operative, the Army and Navy. It is interesting that it did not stay as a co-operative. By the mid 1920s it was investor owned. It hit the troubles with co-operatives with respect to capital, and the variety of ownership interests. There were many different types of member, with different kinds of preferences. However, this was the first sort of

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department store, so it was very entrepreneurial. It is interesting that there was that evolution. Maybe that is happening in the financial services now, maybe not, but at least it is a possible argument.

Some of the other questions were equally interesting: "...is it [investor ownership] a consequence of government policy?" I now give you a prejudice of mine, not based on a great deal of empirical evidence, but it does seem to me, just from economic history and the case studies that were mentioned in the paper, that it is quite likely that detailed financial government regulation is going to have an effect. After all, mutuality was about these high costs of transacting. If you have a Government that says: "We are going to provide all sorts of services to protect you", then an individual does not need to put those defences up. So, I should imagine that there must be some connection, but it will not be the only thing. There has been financial deregulation as well as regulation, so you have two things happening. It is difficult to know which force is more significant. Certainly, if Hansmann's figures are to be believed — and I take this entirely from his book — it is clear that, in the past, mutuals have been a lot safer. I could hardly believe his figures when I read them. In 1933, the worst year of the depression, 25% of investor owned banks failed in the U.S.A., but only 1% of savings and loans associations. So, the savings and loan people may be getting a bad press now, but if you were in the 1940s, you would have had a different view of all this.

Is the future for mutuals in serving the less affluent? This has not been something that has become apparent much yet. The crucial factors are likely to be the heterogeneity of the groups and the size of the groups, rather than whether they are affluent or not. If there is a relationship between mutuality and relative poverty, it is because, as people get richer, they get more diverse, and their requirements become tremendously varied. Mutual governance becomes more difficult. Small homogeneous groups can make a great mutual enterprise. That seems to be the general result. Whether, in certain circumstances, mutuals can grow really much larger and then compete with investor-owned firms, I would not like to comment; I would not like to say that it is impossible. When it comes to areas like monitoring managers, I would not have thought that there was much to choose between a huge mutual or a huge investor-owned company.

Professor Draper: Perhaps I may be provocative on a slightly peripheral matter. One thing that has surfaced in the discussion is the performance of mutuals versus proprietary companies. One of the things that we did in Draper & McKenzie (1998) was to look at the returns on life assurance policies over the term 1970 to 1994, and compare them with a benchmark gilts return and a benchmark equity return using the FT All-Share Index. One of the useful conclusions that came out of that is that all returns on life policies have been poor. I am prone to sweeping generalisations, but it is true. You can allow for the first year premium, in the comparisons, on the grounds that this is going into expenses, and you still find poor results. It seems to be an important policy issue.

It seems to me that there is a management control issue in all of this. This is an issue that has come up several times. How do we get accountability? My argument would be that there is clearly a problem of accountability with mutuals, but the same problem also applies to joint stock companies. Investors have very little control over their savings.

REFERENCE

DRAPER, P. & MCKENZIE, E. (1998). The returns to policyholders from alternative organisational structures: evidence from the U.K. life assurance industry. Unplublished working paper, University of Edinburgh.

Dr L. W. G. Tutt, F.F.A.: The paper prompts me to ask one or two questions in the life assurance sphere. Paragraph 6.4 asks whether mutuals provide an important competitive force in the life assurance market. I agree with those who consider that they do. I held that view quite definitely before I came to this discussion, and, after listening with intense interest to the remarks of the panel members, I have not been deflected from that opinion.

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Paragraph 3.3.8 asks whether the loss of choice is just the price to be paid for progress. May I ask the panel what progress? Indeed, could they be more explicit as to what progress has actually been achieved by many of the demutualisations of life offices?

Paragraph 2.3.3.4 includes specifically the words 'poor management'. I merely pose the question whether, with one very notable exception, managements of mutual offices, in general, have succumbed, perhaps too readily, to the carpetbaggers referred to in ¶3.3.7?

I ask further whether the statement, in ¶6.2, that: "Certainly, members of the profession must fulfil their commercial duties" is pertinent. Indeed, I ask what are these commercial duties perceived to be which members of the profession certainly must fulfil, and whether they are associated fully with the high visions of service and behaviour of our noble profession, also referred to in ¶6.2?

Matters such as the managerial operations of a long-established mutual office, to which reference has been made, have received wide adverse publicity, while, relatively recently, a merger proposed by the management of a large proprietary office did not receive altogether favourable external response, the share price falling on the Stock Exchange virtually overnight by some 30%, never to recover. Also, managerial matters, such as sales operations, investment strategies and the circumstances of orphan assets, have received public attention. Is ¶6.8, entitled 'Professional Issues', relevant in these regards? Dr Hare referred to this point when he asked what such items have to do with the actuarial profession. It is a fact of life, whatever the reasons for it may be, that actuaries within many life offices now have only restricted influence. I ask the panel whether it considers that this might be alleviated to some extent by an external group, such as the Association of Consulting Actuaries, extending their valuable impartial contribution in this sphere.

Mr C. G. Thomson, F.F.A.: What I have heard so far has moved me to give you some of my prejudices, to go along with some of the others that I have already heard. I should like to make a few random points, and then try to give you one slightly more distilled piece of thought.

Policyholders, as owners, are a slightly mixed blessing. The great majority of them do not want to pay any attention to their ownership duties, and a few of them believe that they are the owners and that they can dictate how the company should behave. Neither is actually a satisfactory position, so mutuals do need to understand and to work on what corporate governance actually means, and how it can be managed. Mutuals, in this country at least, in our industry, are hugely tied up with with-profits funds. We need to understand where that is important and where it is not. Certainly, the issues of a with-profits fund and its capital, who it is provided by and where it should go, are issues very closely bound up with mutuality, as I suspect most of us have known it.

The comment that the benefits go to the distributors has been a feature of the post-war era in this country, and it has been dramatically true. In some ways it feels like a market distortion. One would have thought that there ought to be profits to be made at each level of the distribution chain, whether it is manufacturing or distribution.

From my own experiences of outsourcing, it can be a wonderful thing. As an international expert in outsourcing said: "If you outsource something that is working quite well, there is a sporting chance that your outsourcing will be successful, and may even save you money. If you want to outsource something that is not working wonderfully well, or that does not work at all because it is new, do not do it!"

Deregulation was mentioned, and that is not something that I have been well accustomed to in our world. Regulation seems to have been an increasing trend and of increasing tightness.

For those of you interested in savings and loans and corporate governance, diversity of corporate governance is a wonderful thing. I refer you to Frank Capra's 'It's a Wonderful Life', which is nowadays just a Christmas film, but do not take it as just entertainment. There are many serious messages in it.

On mutuals against proprietaries, my more reflective point is that the second law of thermodynamics is alive and well. Entropy increases. If you look at the deals that are done, the

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changes that happen, then, in fact, probably 50% of the changes in our industry are clearly for the worse, 10% are clearly great successes, and, for the other 40%, the jury is still out. As a nation we get the newspapers that we deserve. If we were more selective in what we bought, then we would get more sophisticated media. As an industry, what we are actually getting is the corporate diversity that our regulator deserves. We have regulatory inconsistency. The regulations surrounding credit unions are vastly different from the regulations surrounding the long-term insurance industry. If you applied long-term insurance regulations to the credit unions, they would all disappear overnight. Why is it that we should allow this kind of diversity? It seems clearly inconsistent.

Critical mass is my final point. What we are seeing in business is that, in order to compete, organisations must get larger. In some ways it is a fashion, but in some ways it is a requirement of the modern world. So, the smaller mutuals do seem exposed to cost pressures, and, ultimately, will be unable to survive, and concentration of our industry does seem to be an inevitable consequence.

Mr R. K. Sloan, F.F.A.: I will answer the question that Dr Tutt posed about what progress demutualisations have brought. The generally perceived answer is money. Many policyholders pocketed a lot in windfalls, but they are not the only people who benefit from such changes of corporate structure. We have witnessed a huge surge in change from partnerships to incorporated bodies. The Financial Services Act 1986, of course, brought about all the takeover activity in the many stockbroking firms which had been partnerships. They received a lot of money. Since then we have also had actuarial firms that have incorporated. It is a way of the world — and is an obvious way of capitalising your future stream of profit. However, with the actuarial firms, rather than being triggered by the sea change of the Financial Services Act, the change probably happens when senior partners get near retirement. This is perhaps the same situation as occurs with with-profits policyholders and carpetbaggers. Those who have accumulated the biggest stakes most want to see change.

If we go back to the origins of mutuality, mutuals were central to the early development of life assurance in the late 18th century. To quote from Ricketts (1999), he said: "The calculations involved were so uncertain that investor-owned institutions offering similar contracts would have risked either default or the making of enormous profits for shareholders. A mutual could set the premium prudently high, but then distribute surpluses to the membership as time advanced."

However, times have changed, and so has the financial world that we now inhabit. This includes both geographical globalisation and technical changes from entry into new markets such as banking and investment management. In areas like banking, the payback period can be particularly long. Long payback periods are also associated with products like the new stakeholder pensions, with their 1% cap on expense charges. I came across some evidence given to the House of Commons Treasury Select Committee prior to the introduction of stakeholders by the actuary of a mutual, who said: "If the 1% cap were to become a requirement generally in our business, then it would be difficult for a mutual company to comply with it." In general, in this kind of environment, such very long-term risks and the rewards associated with them, banking would seem to be much better suited to shareholder ownership than to mutuality.

Ownership rights were mentioned by Professor Ricketts. I comment that, for those companies that are still mutual, it might perhaps help if they were to set out their stall as to how they view the ownership rights of their existing policyholders. Interestingly, in the Treasury Select Committee from which I quoted, a Government Minister said that the Government thought that the existing policyholders owned the assets.

As regards a company setting out its own attitude as to ownership rights, one company that implemented demutualisation well, in terms of the distribution, was Friends Provident, which, rather than distributing in proportion to existing policy values, which tends to be the normal assumption, based this on the increase in asset share over premiums paid. This offers relatively little to recent entrants to the company, and thereby acts as a significant deterrent to

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carpetbaggers, which must be a good thing. So, it could help to diffuse some situations if mutuals were to explain how they might apply demutualisation if they were to follow this course, or state if they would adopt the community concept of locking surplus away for ever.

Mention is made in the paper of consumer choice and whether any restriction therein was to be regretted. I do not feel that this sort of generalised question is really appropriate. We are not talking about fashion clothing or something like that, but the hard-nosed provision of financial services. The irony here is that the success of most financial products depends on sound investment in the shares of proprietary companies. In other words, no investment institution could survive if all organisations were mutual. That is obviously a truism, but it is nonetheless relevant.

Regulation does, indeed, reduce the advantage of mutuality. Again, quoting from Ricketts (1999): "The growth of state imposed financial regulation to some extent substitutes for mutual status.'' Then, with great prescience, given the subsequent Equitable Life experience, he added: "Whether Government regulation is an effective substitute is another matter.'' However, the irony of that situation was that mutuality was itself far from helpful to Equitable Life in its situation, and arguably contributed to its eventual downfall, if I can call it that.

Are there any real differences between the levels of accountability in mutuals and in proprietary companies? It has been suggested that there is not much, but I have to say that the answer is a resounding 'yes', there is a difference. The combined code of good governance applies only to plcs and not to mutuals. As a result, even seemingly straightforward issues, such as the composition of audit committees (do I hear Enron?), the composition of remuneration committees, and so on, get fudged over to the detriment of the company's owners; that is its with-profits policyholders. There are many other defects in the structure and in the corporate governance of mutuals, in which I include building societies as well as life offices. There have been things like undemocratic restrictions on director nominations, election procedures and unfair use of proxies — the situations abound. So, we need better accountability.

On a conceptual level, there has been mention of the distinction between the less affluent and the high net worth customers. I agree that it is the homogeneity of the risk of the group that is important.

If mutuals are to have an important role, which I think that they do have in this industry, they could send out helpful signals in the area of commission. It would seem entirely logical for them to impose a cap on the commission for a single transaction — for argument's sake, say £3,000 on the sale of a with-profits bond or a similar product. There are, of course, new proposals in the offing for changes in the way in which financial services operate in this regard. The current practice of life offices buying business from IFAs would seem to be the very antithesis of the mutual concept of putting the customers first. The mutuals could set out their stall on this. Unfortunately, Equitable Life went far too far the other way, by suggesting that there was something magical about not paying commission to anybody, which was being totally unrealistic.

On the professional issues raised in ¶6.8, we should be concerned that the existing structures work effectively rather than necessarily worrying too much about whether we create new mutuals or that any more disappear. I have referred to corporate governance and accountability where we could press for better conduct. Our concern should not so much be the means of product delivery, but the financial security, professional probity and high standards in these areas.

As regards the structures of the organisations, as Professor Draper has said, we should let the markets decide whether mutuals survive or not rather than the profession wanting to impose itself in any way on this issue. Let us get the best possible governance for the mutuals, and let them set out their stall in those features where they can do things better than the proprietaries, and then the market can decide.

Mr P. H. Grace, F.F.A.: Appendix A refers to my former employer, Scottish Equitable. One point not made in a very fair summary of its demutualisation schemes is that the with-profits sub-fund is effectively still mutual, and remains open to new business. I also mention that one

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result of phasing the sale to AEGON of the non-profit and unit-linked business was the receipt, in total, of a significantly larger consideration than the grossed up equivalent of the amount mentioned in the paper. I have an ongoing involvement with the voting trust company which is referred to in the paper. That company was formed, not only to exercise the voting rights mentioned in the paper, but also, as part of the corporate governance, to represent the policyholders' interests in the with-profits sub-fund.

Also, Appendix A does not make it clear that, in the case of both National Provident and Scottish Life, their new owners do not have a financial interest in the former mutual's with-profits fund, although, unlike Scottish Equitable, their with-profits funds are effectively closed. In both cases, a structure has been put in place to represent policyholders' interests in the closed fund.

On the question of accountability, and hence efficiencies, mentioned in ¶1.2, and at the same time the question in ¶6.4: "Do mutuals provide 'an important competitive force in the marketplace'...?", in the early 1990s, before the demutualisation era got underway, the mutual life offices' products featured well in past performance tables, and they maintained their market share, demonstrating that they could be a competitive force. At the same time, tables on expense ratios, ABI inter-office expense exercises and other similar work indicated, perhaps more by luck than by good judgement, that many of the mutuals were operating as efficiently, if not more efficiently, than their proprietary competitors. However, it would be true to say that shareholder structure does lead to more focus on efficiency, but not necessarily for the benefit of policyholders.

Another question that I should like to comment on concerns the regulatory effect on mutuals. Mr Hill remarked that most of the demutualisations that have taken place have been management driven. That is true, and is fair comment. It has been management driven, because managements have recognised the impact that regulation and increased capital requirements were going to have on their operations, and they had to find ways of seeking additional capital. If one reads the summaries in Appendix A, it is interesting to note how the various mutuals raised capital in their early days. They effectively went down the traditional route, and persuaded wealthy people to stump up the capital that they needed.

These facts would be lost on the present generation of policyholders. It is true that, for many years, mutuals only talked about the upside of mutuality. They referred, in their sales pitch, to the fact that all profits belong to policyholders. None of it would go to shareholders. The mutual offices did not talk about the downside, the risk of losses or, more importantly, the need for capital. Perhaps the actuarial profession should have influenced the sales message more at that time; in particular, to make clear the need to create capital by holding back some of the surpluses. If so, perhaps the regulatory requirements on mutuals would now be less, which, in turn, would have meant less need for mutuals to demutualise in order to seek capital.

Mr J. Goford, F.I.A.: Mr Snaith talked about the shareholders' interests dominating proprietary companies. My observation about proprietaries is that, once you get inside the company and start dealing with the management, that is just not true. There is recognition of shareholders, but there is a recognition that doing the right thing for customers and employees is good for shareholders, and the shareholders benefit from that as a consequence rather than as a driver. That observation can be built on to improve some of the internal governance, particularly of with-profits funds, by recognising more specifically what the various interests are within the with-profits fund. Certainly they include shareholders; certainly they include future with-profits policyholders; certainly they include the estate, in so far as the ownership of the estate is undefined; and there are probably three or four different competing sets of interests of existing policyholders.

I should like to see a more open and transparent acknowledgement of these interests in the reports of the actuaries to the board. What that would do specifically is that there would have to be a demonstration of the value of the return on the estate. Imagine what the report of an actuary would be whose sole principal was that of the estate, whose ownership is as yet

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undefined. It might be quite illuminating on the use of the estate to support excessive commissions on with-profits bonds, on expense overruns, underpriced for guarantees, and the like.

Moving to the fruits of competition that go to the intermediaries, it has always struck me that you need rules when competition does not work. It has been in front of our noses for many years that competition increases commission rather than reduces it. The industry did make some attempts with maximum commission agreements a while ago, and was told that that was anti-competitive and therefore banned. However, I do think that it is time to seek permission for the industry to make its own arrangements for a maximum commission agreement or some modern equivalent. Such an agreement must recognise that IFAs have to have a reasonable income. It might be time to start thinking internally on some self-regulation on commission.

My experience is that management in proprietaries and mutuals is totally different. You certainly feel the implied hand of shareholders inside a proprietary which you do not feel in a mutual, but the costs of satisfying that implied hand are quite high in proprietaries.

So to conclude: "Where does ownership lie?" I end up with the thought that ownership lies in the thinking of the personally dominant managers.

Mr H. R. D. Taylor, F.F.A.: In my career I have worked for a mutual life company, which became acquired by a plc bank, which then subsequently acquired another mutual life company, so I have some experience of the way in which organisations change shape and the way in which management teams within them change shape.

Paragraph 2.3.3.4 mentions that poor management performance can outweigh structures. The converse is equally true, a good management performance can transcend corporate structure. We should always be aware of that.

Paragraph 6.5 addresses market concentration. One of the biggest potential drivers for market concentration is coming from the FSA as regulator. If the proposals in Consultative Paper 121 go ahead as currently proposed, it is highly likely, over the next few years, that this will prove to be the major force in accelerating consolidation within U.K. financial services.

Paragraph 6.7 concerns mutuality issues. To broaden that, I would ask that, if you wanted to compare and contrast the different structures, what would you be trying to measure? You may try to identify whether any of these structures would have particular advantages either to policyholders or to those who chose to invest in them. Would they create any opportunities for arbitrage, whether that was regulatory or taxation or in terms of access to markets? Would any give rise to a source of sustainable competitive advantage?

With these points in mind, I then considered how each of the different structures would behave in a changing environment, and what the criteria are that we would be looking at:

(1) the safety and security of those who have money invested; that is to say risk management and access to capital;
(2) the value for money provided for people who purchase the products;
(3) the service to customers and distributors;
(4) the fairness of any discretions that might be exercised or be exercisable by the entity;
(5) short-termism and long-termism; a point well made in the paper, as there are huge pressures on plcs to produce short-term performance; and
(6) the efficiency aspect, which is a major topic in the Sandler Review.

You could look at all of these elements and could analyse one against another in terms of the structures that exist, based on mutuality or plc or any other variants. This analysis would be interesting, but is missing the point; the biggest driver for how each of these structures operates is coming from external intervention in the marketplace. The FSA is hugely interventionist in the U.K. financial services marketplace, and the Treasury probably has equally strong aspirations. We have seen this in a number of areas around products. We have CAT standards and 1% charging caps on stakeholder pensions. The ultimate users of the products which are provided by U.K. financial services, plc or mutual, are the end customers. There is a huge growing power

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and influence of customers in the U.K. To an extent it does not matter which particular corporate structure exists, because any freedoms or opportunity for arbitrage or discretion will disappear over the next few years because of the regulatory regime in which we are working. Then competitive arbitrage will revolve around such issues as quality of management and access to capital.

Then, ¶6.8 considers the actuarial profession. It is my perception that in mutuals 'the actuary is king', whereas in plcs, particularly if the plc is a bank, you find a much heavier weight of other professions in the management team. You find many accountants, managers with MBAs, and external consultancy influence management decisions. There is more competition for actuaries developing careers, and if you work in that environment you have to acquire new skills. This creates both threats and opportunities for the actuarial profession. I think that the opportunities outweigh the threats.

Dr L. M. Pryor, F.I.A.: Professor Ricketts spoke about mutuality possibly being based on high transaction costs. I was wondering why this issue arises in the financial services industry rather than in other industries. I know that there are mutuals and other forms of corporate governance in other industries, but not to nearly such a large extent, and it does seem possible that it is to do with the long-term relationships that customers have traditionally had with insurance companies and with building societies. It used to be that you took a mortgage out, you repaid part of it every month, and 25 years later you finished paying it off. What we have seen in the last few years is a lessening of commitment on the part of customers. There has been a decline in with-profits business, and a corresponding rise in more unbundled products, such as unit-linked products. If you look at the consumer finance pages in the weekend papers, nobody seems to keep a mortgage for longer than about six months. Maybe that is a contributory factor in the drive towards demutualisation that we have seen in the financial services industry, and maybe that is going to continue, because buying a financial services product is becoming more like buying a loaf of bread, and, although we do have the Co-op, of course, on the whole, our bakers are not co-operatives.

Professor A. D. Wilkie, C.B.E., F.F.A., F.I.A.: One of the things about setting up a mutual is that you do not require huge amounts of fixed capital. You do not have mutual oil refineries or mutual steelworks or mutual power stations, because you need to put £billions into those in the first place. So, shareholder capital is the right thing for them.

The second area is risk capital. Building societies, as they worked originally, only lending on mortgages, were pretty low-risk institutions if they did not lend too much of the capital, and, as Dr Pryor said, they did not have too much churning of the loans. The whole thing ran very smoothly, whereas ordinary banks were lending much more to businesses that might lose money and needed a lot more risk capital. As the building societies wanted to move into other fields, they started needing more capital.

Another type of mutual organisation that has not been mentioned is the club. Clubs may, through some other legal form of trustees or whatever, own property. If the members of a club have a valuable property or a property that happens to become very valuable, such as the members of a golf club that owns a lot of valuable land which could be used for some other purpose, who owns the surplus? That seems a problem that the RAC got into rather recently. People who thought that they owned the surplus found that they did not.

Another type of mutual institution that exists in large numbers is the investment trust. The obvious way of running an investment trust as a mutual is to turn it into a shareholding company. There seems to be no other way of running an investment trust except as a shareholding company. It has only investors; it has almost no employees and almost no customers and almost no suppliers, but, of course, it has a management and directors to run it. However, it is really very cheap compared to the quantity of money. It is an interesting form where a mutual would necessarily become a shareholding company.

As regards the Scottish mutual insurance companies, over the years one of the things that I

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have felt is that they have not defended their mutuality very well. To give Equitable Life credit, as a policyholder of it, I had a copy of the annual accounts every year, even though I had a non-profit term assurance under the guise of a personal pension. I suppose that I could have gone to the general meeting. I do not know whether I had a vote. At the time I was reasonably confident. My term assurance policy never got paid, but I am still here to prove the point!

The Scottish companies did not generally distribute their annual reports to their members. Most of the members would not really have known that they had a vote. The management seemed to want to keep the nominal owners at arm's length, and, as has been pointed out, most of the demutualisations have been initiated by the managers. It is, perhaps, not surprising that many of the policyholders decided that carpetbagging was the right approach, take the windfalls and go, because they have not really felt involved with the management of the company. If the surviving mutuals really want to keep mutuality going, then they need to do something more to get their policyholders to understand that they are the ultimate owners of the business. However, a point that Professor Ricketts and Dr Pryor made, regarding the diversity of different types of policyholder, with-profits and non-profit and unit-linked and pensions business and ordinary life business, may have meant that the transaction costs of running a fair mutual, even a proprietary company that has much with-profits business, has become too difficult. The movement may be simply towards unit-linked business, because that is simpler.

Mr W. B. McBride, F.F.A.: I am very much in agreement with the President, as quoted in ¶1.4, and as he confirmed in this discussion; that it is desirable for several forms of ownership to survive, and for new life companies to be regularly formed. Variety is indeed the very spice of life ... assurance!

The early histories of a sample of insurers given in the paper show the diversity of structures and types of offices started, and also show how the founding of one office often led to another. The Amicable was founded in 1706, and the published history of London Life, where I used to work, tells us that a mathematician called James Dodgson was declined around 1750 by the Amicable on age grounds, which so irritated him that he became the inspirer of the founder of Equitable Life. It is unlikely that we will see new life offices set up in quite that manner in the future!

London Life was founded as a mutual in 1806. A Mr Syms had spotted what he took to be a gap in the market. The surplus was then, as now, almost always distributed as bonus payable with the sum assured, but Mr Syms reasoned that, since a man knew how much he wished to provide for his family, there would be many who would be prepared to have the amount payable on death fixed, with profits being applied towards reducing the premiums. This became, after advice from William Morgan, Actuary to the Equitable, the basis of London Life policies issued at the outset and a form in which they still exist. I have one.

So, it seems that fundamentally nothing much has changed over the last 200 years. Spotting a market need, whether contract type or lack of coverage of particular classes of life, still leads to new ventures; witness the Pension Annuity Friendly Society, described in Section 3.4. Friendly societies today still trade heavily on the tax privileges that they enjoy relative to life offices, and also have a lower minimum guarantee fund, although in ¶3.4.6 it says that that might not last. It will be remembered that, in the 1980s, Mr Geoffrey Howe, as Chancellor of the Exchequer, increased the out-of-date premium limits for friendly society endowment policies, and a rush to found new societies followed. Alas, his successor, Mr Nigel Lawson, cut the limits back again, and many of the new societies either closed or merged, proving that the markets can be bucked — by the politicians!

What are the chances of forming new mutuals today? Section 3.4 does not sound too hopeful, seeing niche markets as the most likely prospect. Some of the issues are discussed in ¶6.7, and I see nothing wrong with small mutuals, if successfully led. There are many solutions available to deal with strain on capital, as ¶3.4.8 shows, and some of the panel have commented on these lines. I particularly like the 'French lock' mentioned in ¶4.6.4. I would like to see that here to help mutuals.

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However, it seems to me that the greatest threat to mutuals is hinted at in ¶6.7, where there are questions about regulation. Several speakers have mentioned regulations, and Mr Thomson made the point that we get the corporate diversity which our regulators deserve. That is absolutely right.

With-profits business is at the heart of mutuality, but current regulations, by looking towards reserving for terminal bonus, publication of asset share methods, telling us what PRE means, or maybe trying to, is driving hard against the fundamental concept of with-profits business. Worthwhile profits cannot be made without the freedom to run the risk of worthwhile losses. No amount of regulation can stop or eliminate the prospect of losses without killing the goose that lays the golden egg — possibly not even then. In this connection, I share many of the concerns of Dr Tutt. On the professional issue, much as I am a mutualist, I do not think that the Faculty, as such, should be proactive in sponsoring mutuality. I do not think that that is necessarily what the questions in ¶6.8 had in mind, but there is a suggestion of it. Also, ¶6.8 includes: "helping to shape the development of the U.K. financial services marketplace", which possibly presumes that we know what shape that should be. Although the profession, as such, should not get involved in sponsoring mutuality, we could, perhaps, give indirect support to Mutuo, mentioned in ¶5.3.2. This might be by setting up some kind of advisory panel inside the Faculty with members consisting of volunteer mutualist actuaries, if we can find any apart from myself.

The President (Mr T. D. Kingston, F.F.A.)(summing up)**:** One area where there is a considerable need for new products and new companies is in the area of annuities. For example, what happens if compulsory annuity purchase is done away with? There is a real prospect of that happening, just as it has happened in Australia. Yet, there remains a huge risk of longevity, and in some way that risk needs to be pooled. Mutuals began many years ago, when mortality was relatively uncertain. Today we do not have much idea, at this stage, of how longevity risks will pan out. I wonder whether this is an area where there is a call for some form of mutuality, where people who are not buying annuities can, in some way, pool their risks of longevity. That is something which we should consider.

Mr Snaith (summing up)**:** Free markets and deregulation are, in a sense, where the concept of greater accountability of management in listed plcs comes from. However, it is always wise to bear in mind, as I guess a lawyer would say, that the rules that surround the market in the end are a matter of legal regulation, and, however free the market, the way in which the law regulates the possibility of different structures is going to have an effect. There will always be a distortion, however free the market apparently is. One role which the Faculty, if not individual actuaries, could play is to remind politicians and administrators that decisions can have effects on the mutuality proprietary debate, and almost always that will be an unintended consequence. They do not think about it, but just go ahead without any regard as to the effect that it would have on this issue.

Mr Hill (summing up)**:** My point about outsourcing was really trying to get across the concept that mutuality extends all the way from just being an affinity group, to being part of a pool that may be managed by external shareholders, to being in a with-profits fund, all the way through to a full mutual, and maybe there are many more ways that the whole thing can be looked at now. You could have virtual mutuals which do not do anything apart from look after the policyholders and segment out the services, which is really where the Government was coming from on stakeholder services. I was really trying to make the case for more diverse views about what constitutes mutuality.

Professor Ricketts (summing up)**:** Mr Thomson said that I had mentioned deregulation. I was referring, of course, to the Big Bang and the globalisation of capital markets. The overall thrust of my comments was to emphasise the way that individual enterprise is becoming much more closely regulated, but, in the context of an extremely international environment, and, from that point of view, a more deregulated financial market.

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On the question of the approach of the law to mutuality, I am not an expert on this, but one of the things that impressed me about the Equitable Life judgments was that contract dominated other 'ownership' considerations. I am not a lawyer, so I hesitate to say anything in public, but I did read those judgments, and, apart from Sir Richard Scott's original judgment, which seemed to be quite good, all the rest simply did not take any account of the fact that there was a mutual element and that these people were members. They might have had contracts with any other kind of company so far as I could work out. A lawyer may be able to correct me, but as a non-lawyer, having read them quite carefully, I could not see any reference to mutuality, and so contract was what mattered. If that is the way the law is going to be, contract trumps everything. Contracts are not going to be read in the context of a more general kind of membership relationship with the society. The contract could have been with the Equitable Life or it could have been with anybody else — it would have been interpreted in the same way so far as the Law Lords were concerned. That interests me, because that is bad news for the mutuals.

Professor Draper (summing up)**:** One point which deserves attention is the impact of competition on commission. We have seen, in a variety of areas, unit trusts being a good example and life assurance another, where apparently increased competition actually results in higher levels of commission.

The regulatory position, I suspect, would be that what we need is education, but I cannot help but feel that this is misplaced. Experience suggests that more regulation, in terms of commission levels and expenses, is the way that we ought to be going, quite contrary to present policy. There does not seem to be much evidence that competition, *per se*, works in financial services in this area. I cannot help but wonder if people's greed overwhelms all other motives, and they lose sight of the average return and consider the extremes.

The President (Mr T. D. Kingston, F.F.A.): I thank Dr Hare and Mr Guijarro for starting this very interesting debate. A lot of matters have been raised. I should like to thank Professor Draper and the panel for their contribution, and thank you all for being here.

WRITTEN CONTRIBUTION

Mr D. I. W. Reynolds, F.I.A.: It seems to me that the profession should debate diversity in financial services, but that it need not be limited to forms of ownership. It is just as important that there is diversity in size of organisations and in the products, services and service standards that they deliver.

Unfortunately, there are considerable pressures to incorporate the economies of scale that come from merger and integration. Our regulators, the Office of Fair Trade, the FSA and the Treasury seem fixated on price and costs. Perhaps, surprisingly, consumerist organisations seem to follow in the same footsteps. Maybe mutuality and economies of scale are incompatible. It is commonplace to hear that large mutuals are run in the interests of the management, even if it would be difficult to cite chapter and verse to support this claim. It may be worth commenting on the information in Appendix A that indicates that several of our current mutuals only took that constitution after they had got to some considerable size.

In addition, there are calls for more information to be given to customers and for greater transparency in how products and companies operate. Whilst we should support that in principle, it is hardly beneficial if it results in only large organisations being able to cope with the system and the compliance demands that that imposes. It should be possible to provide a more expensive or less transparent service from a small mutual selling to a geographic or other connected customer base.

However, as a profession, we should be considering how a mutual can separate the benefits of membership from the products that it provides. It may not be sufficient to claim that the terms of the contracts include the benefits of membership.

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Also, may I suggest that the authors have omitted one set of mutual organisations that may be closer to the original concept. They are investment clubs.

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