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AFM Response to FRC consultation on the UK Corporate Governance Code

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, and
 - Explore the consequences for the AFM Corporate Governance Code.

About AFM and its members

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 32 million people in the UK and Ireland, collect annual premium income of over £22 billion, and employ nearly 30,000 staff¹.
3. The nature of their ownership and the consequently lower prices, higher returns or better service that typically result, make mutuals accessible and attractive to consumers, 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 businesses² and to take account of corporate diversity³.

¹ ICMIF and AFM, 2022: <https://financialmutuals.org/wp-content/uploads/2022/10/UK-Market-Insights-2022.pdf>

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>

AFM comments on the proposals

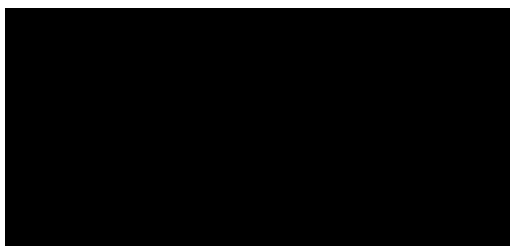
4. We are pleased to respond to this consultation. The FRC Corporate Governance Code is widely acknowledged as world-class, and the fact that this is the first review since the current version of the Code was issued in 2018 is testament to its continuing relevance and value to listed companies.
5. The AFM Corporate Governance Code was introduced in 2007, in response to concerns about the governance standards in life insurance mutuals, following the failure of Equitable Life. Initially the AFM Code closely mirrored the format of the FRC Code, and whilst in recent times we have moved to an 'apply and explain' model similar to the Wates' principles for large privately owned companies, our Code carefully reads across most of the principles in the FRC Code for listed companies. As our members are also regulated jointly by the PRA and FCA, we are careful to ensure the AFM Code helps our members interpret and incorporate regulatory requirements as well; particularly PRA's Board Responsibilities paper, SS 5/16⁴.
6. In submitting this response, we are also taking account of how possible changes to the AFM Code, intended to reflect the final changes to the FRC Code, might impact our members. We will consider whether and how to adapt the AFM Code once FRC has finalised its consultation process. The plan to implement the changes for financial years commencing 1 January 2025 onwards is welcome, in giving time for us to assess how to amend the AFM Code.
7. Since AFM members do not have shareholders and are on the whole small businesses, we have focused our responses on the questions posed, to those changes that might have a more specific impact on AFM members if also incorporated into our Code.
8. Also, since the AFM Code is principle-based, and we expect members to draw together the most relevant evidence of how they apply the principles in the AFM Code, we are providing general comments in addition to responses to the narrow set of questions posed. Our feedback is:
 - a. It is interesting to see that the number of firms that chose to offer explanations to some of the provisions more than doubled in the FRC's latest review, from 27% the year before, to 58%. We agree this is a positive, where firms are electing to take advantage of

⁴ <https://www.bankofengland.co.uk/prudential-regulation/publication/2016/corporate-governance-board-responsibilities-ss>

flexibility in the Code to set out a solution that is more tailored to their business. It might also be a reflection of where the Code needed review, to reflect today's operating environment.

- b. We welcome the greater focus on the reporting of governance outcomes in the proposals, since this is the key evidence to stakeholders that the business is well-run, as opposed to whether it has adopted all the expected policies and practices.
 - c. Within the consultation, and during a webinar in July, FRC staunchly defended the absence of guidance on some important elements of the Code, and sought to put responsibility on Boards to determine for themselves how to meet the expectations. However, this has led to concern that consultancy firms are increasingly setting standards, particularly in relation to the approach to internal controls. In the absence of guidance from FRC, those consultancies are turning to the US SOx for evidence of best practice, and this is driving up expectations and costs to an unjustified level. We consider more guidance can be issued by FRC without providing safe harbour, and this would help firms to better assess the nature of advice they are receiving.
 - d. The expectation that smaller Public Interest Entities should consider adopting the Audit and Assurance Policy (AAP) and a Resilience Statement might have consequences for small AFM members, as the Solvency 2 rules mean that all insurers in the scope of Solvency 2 are also treated as PIEs. We have previously raised concerns to FRC and the Department for Business and Trade on the impact of the PIE regime on small mutual insurers, and await final policy decisions on 'Restoring trust in audit and corporate governance'. Note that the inference in paragraph 5 that PIEs are generally companies with more than 750 employees and turnover of £750 million is misleading, seeing as the PIE rules also apply to every Solvency 2 insurer, a number of whom have fewer than 20 employees and less than £10 million turnover.
9. We would welcome the opportunity to discuss further the issues raised by our response. We are happy to be included in the published list of respondents.

Yours sincerely,



AFM responses to questions raised in the consultation

Q1: Do you agree that the changes to Principle D in Section 1 of the Code will deliver more outcomes-based reporting?

We support the focus on the reporting of outcomes of a firm's governance activity, since this is a practical way for stakeholders to judge whether those actions are having a worthwhile effect, and to better judge whether the outcomes being achieved are consistent with the values of the company, or of its stakeholders.

Q2: Do you think the board should report on the company's climate ambitions and transition planning, in the context of its strategy, as well as the surrounding governance?

We consider the climate change ambitions of a firm are today a critical element of its overall strategy. The treatment in the Code might be considered to understate the importance of the topic, particularly considering the range of attention given to action on managing climate change from the government and regulatory bodies; however in doing so it helpfully avoids creating competing demands. Moreover, we recognise the attention FRC is giving to how firms are reporting their climate ambitions, including the July publication on metrics and targets, which helpfully highlights how reporting is changing in this rapidly moving area.

Q3: Do you have any comments on the other changes proposed to Section 1?

We welcome the added focus on the embedding of culture. The Board has a key responsibility for setting the right culture in a business. Reporting on the effectiveness of how the culture is embedded will cause firms to think carefully about what the culture is now and what they are looking to instil, as well as what evidence they have to show that the culture is moving in the right direction, and/or the business is learning from culture failures.

As mutual businesses, who are owned by their customers, we welcome all drives to increase active engagement with stakeholders, and we will consider how to encourage more engagement with members of mutuals (who unlike shareholders, become owners of the business as a by-product of buying an insurance product).

Q4: Do you agree with the proposed change to Code Principle K (in Section 3 of the Code), which makes the issue of significant external commitments an explicit part of board performance reviews?

We consider this is an issue boards should consider for themselves. Whilst the issue is sound in principle, the singling out of external commitments is puzzling:

the performance review of directors should also give proper focus to many other issues, including business strategy and risks.

Directors' commitment to the company may be jeopardised by the range of other commitments they have, and it is important that this is taken into account in evaluating, *in the round*, their performance and continuing suitability.

For individual board directors, someone with a range of external commitments might use these to the benefit of the board. In addition, the wording may be too narrow: one external appointment as Chair might conflict with a person's ability to add value, whilst the reference to 'other organisations' is too narrow, as there is a range of activities that might distract a director, or effect their contribution (e.g. charitable or trustee work, or a role in independent audit committee work should be picked up in the evaluation). The Chair is not immune to this, so careful consideration is necessary of how this information is assessed.

Q5: Do you agree with the proposed change to Code Provision 15, which is designed to encourage greater transparency on directors' commitments to other organisations?

We agree with the greater transparency, though we think the wording proposed for CP15 is open to interpretation, and the current wording seems more appropriate. The Board should consider the issue on appointment, and we suggest the amendments proposed for Principle K might be better placed here, to prompt review annually.

We think this is valid information for both Executives and NEDs, though inclusion in the ARA captures only one point in time.

Q6: Do you consider that the proposals outlined effectively strengthen and support existing regulations in this area, without introducing duplication?

The narrative in the consultation indicates it is FRC's intent to align the requirements in the Code with those of FCA's listing rules. That may not be appropriate for a lot of firms, but for those for whom it is, a degree of duplication seems inevitable. More generally, where all organisations seek to account for their actions on diversity today, there is an increasing challenge for directors to evidence that a small group of people can adequately replicate the vast range of protected and non-protected characteristics. We prefer greater focus on a principle-based approach, that encourages firms to weigh up the various characteristics of its directors against the needs of the business, though we accept there will be some firms who may be less diligent, and that therefore some guidance is necessary.

Q7: Do you support the changes to Principle I moving away from a list of diversity characteristics to the proposed approach which aims to capture wider characteristics of diversity?

We consider this may be difficult for firms to adopt, since the list of ‘non-protected characteristics’ as referred to in Principle I are not well-defined or as easily identified. We suggest this may be addressed with more guidance on non-protected characteristics, as well as a reminder about protected characteristics, to ensure none are overlooked. Alternatively, the references to non-protected and protected characteristics might be removed to simplify the intention.

Q8: Do you support the changes to Provision 24 and do they offer a transparent approach to reporting on succession planning and senior appointments?

We support these changes.

Q9: Do you support the proposed adoption of the CGI recommendations as set out above, and are there particular areas you would like to see covered in guidance in addition to those set out by CGI?

We agree.

Q10: Do you agree that all Code companies should prepare an Audit and Assurance Policy, on a ‘comply or explain’ basis?

We support the introduction of the audit and assurance policy, as the BEIS response said, to set out “a company’s approach to assuring the quality of the information it reports to shareholders beyond that contained in the financial statements”⁵.

We agree that the AAP should be prepared every three years. We suggest the full AAP should be available to download from the firm’s website.

Whilst the AAP would detail what nature of assurance a firm has adopted for non-financial areas covered in the report and accounts, we do not think that this should imply that external audit is the natural or preferred route for assurance on every occasion. We note that this is recognised in the draft government regulations, published since the FRC consultation was issued⁶: this is targeted at very large companies only. We consider that for organisations below this threshold (of 750 employees and £750 million revenue), the Code should specify that rigour and assurance are vital, though that the monitoring of implementation of the AAP might be achieved via internal independent review (such as by internal audit), rather than to always revert to external assurance.

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https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1079594/restoring-trust-in-audit-and-corporate-governance-govt-response.pdf, paragraph 3.2.1

⁶ <https://www.gov.uk/government/publications/new-transparency-over-resilience-and-assurance-for-big-business/corporate-reporting-the-draft-companies-strategic-report-and-directors-report-amendment-regulations-2023#introduction>

Whilst we think the AAP provides some valuable safeguards for stakeholders, we don't agree that in isolation this will address the low levels of "engagement between shareholders and audit committees" (paragraph 40), and suggest FRC considers further how to achieve this ambition.

We note that FRC encourages all Code signatories to adopt an AAP, not just the large PIEs proposed in the Government's proposed approach. We do not feel that the FRC has made a strong enough case for going beyond the expectations of the government.

Should FRC maintain this position, we will take it into account in reviewing whether to amend the AFM Code. For smaller, non-listed firms such as AFM members, that may mean exploring how the AAP and the Resilience Statement can avoid being over-prescribed, and how existing PRA/ FCA requirements are factored in to avoid duplication of effort. As the consultation has been issued before the content of the AAP has been finalised, we consider the comply or explain approach might extend to what parts of the legislation were incorporated into the AAP, as well as what parts of the AAP were adopted.

Q11: Do you agree that amending Provisions 25 and 26 and referring Code companies to the Minimum Standard for Audit Committees is an effective way of removing duplication?

As AFM and its members are not signatories of the FRC Code, we prefer not to see the Code document signpost to other FRC documents. The main benefits of signposting are version control and brevity, but for significant issues we consider there is more to gain from providing a fuller description in the Code provisions, and that this will focus the work of the Board and Company Secretary, by seeing the expectations set out in one place rather than across different documents.

We also see a danger in signposting from the Code to other documents, that unless there is an express intention to align the review of all these documents using the same formal consultation process, then signposted documents might create higher standards than would be mandated under a proper consultation process.

Q12: Do you agree that the remit of audit committees should be expanded to include narrative reporting, including sustainability reporting, and where appropriate ESG metrics, where such matters are not reserved for the board?

We agree that the audit committee (where there is one) should have responsibility for monitoring the integrity of narrative reporting, including sustainability reporting, as per paragraph 51 and Provisions 26 and 27.

We do not agree with the way this is set out in Q12, which appears to imply that the committee is responsible for the production of narrative reporting and metrics, rather than for "monitoring the integrity" of them, as stated in the draft Code.

We also suggest care is taken in the wording to recognise that the assurance role played by a firm might be different depending on the degree to which it relies on externally-produced data. For example, where an insurance company identifies that 99% of its carbon-emissions are scope 3 emissions, then where it outsources fund management, it is relying on third party produced metrics, and its assurance role may focus on verifying the integrity of the data process, rather than of the data itself.

Q13: Do you agree that the proposed amendments to the Code strike the right balance in terms of strengthening risk management and internal controls systems in a proportionate way?

We support the need for the Code to strengthen board accountability in relation to internal controls. We agree that this means the board should be responsible for maintaining the effectiveness of the risk management and internal control framework. We further agree that the annual report should include a declaration by the board that the risk management and internal control systems have been effective, as well as the basis for this declaration, and a description of any material weaknesses identified and the action taken. We note that the Government was adamant that it should be for the board to determine the nature of assurance required for this statement (via the AAP), and therefore that this did not imply the declaration would be subject to external audit unless the board/ audit committee concluded this was the appropriate form of assurance needed.

The consultation appears to seek to expand the range of audit oversight, by expanding the review of material controls, to cover all reporting. We agree that it is important to focus greater effort on verifying the appropriateness of narrative reporting, to ensure the annual report accurately informs stakeholders about the approach taken within the company. However, for small firms, should this lead to further extension of the external audit, this will have significant consequences for both the cost and availability of audit. In response to the Government consultation, one audit firm appear to suggest an increase in fees of between 15% and 35%, and that competition for audit services meant it could take up to three years to bring all firms into scope. These are vital issues to take into account.

The directors' declaration on risk management and internal controls is likely to be a significant undertaking. In order for this to be effective, it is important FRC produces guidance on what the declaration should cover, and to set out the minimum baseline of activities that would be necessary. As EY stated in their submission: "It should not come down to the audit or assurance profession to have to determine what this minimum baseline should be"⁷. Firms will be concerned that this will lead to a broadening of scope, as was the case in the US when similar expectations were provided in the US SOx. Further guidance, to reiterate that

⁷ https://assets.ey.com/content/dam/ey-sites/ey-com/en_uk/resources/corporate-governance-code-consultation-2023.pdf, page 3

external assurance is not the norm, but on how firms determine when to adopt an external review, would be helpful.

Given the very high costs that are likely and should FRC continue with this proposal, when we review the AFM Corporate Governance Code, we will consider whether it is proportionate to burden mutuals with these high costs, as they are not in scope of the Government's proposals.

Q14: Should the board's declaration be based on continuous monitoring throughout the reporting period up to the date of the annual report, or should it be based on the date of the balance sheet?

We would expect monitoring to take place by the board, and that the Code should stress the Board's responsibility for regular monitoring through the year.

However, we consider the declaration should be based on control effectiveness as at the balance sheet date. There is no risk to year-end reporting of weaknesses that arose during the year which were resolved before year-end, or those that arose post-balance sheet. Equally, a declaration that set out the effectiveness of controls throughout the whole year would be disproportionately expensive.

Q15: Where controls are referenced in the Code, should 'financial' be changed to 'reporting' to capture controls on narrative as well as financial reporting, or should reporting be limited to controls over financial reporting?

We recognise the likelihood that changing the scope of controls to narrative, as well as financial reporting, will expand the nature of those controls, albeit many are already covered in regulatory requirements for financial services firms. This will help to drive up standards in the approach to narrative reporting, including ESG measures. However, this has to be adopted in a proportionate way, to take account of the likely cost and complexity, as well as the prospect of external auditors and consultants interpreting the standards expected in a very cautious manner.

Q16: To what extent should the guidance set out examples of methodologies or frameworks for the review of the effectiveness of risk management and internal controls systems?

The proposed guidance set out under paragraphs 70 and 71 suggests that the nature of the directors' statement/ declaration will be extensive; i.e. the description of the process adopted, the role and work of the board, and other committees/ individuals, and the framework used to evaluate the effectiveness of the systems used to monitor the company's risk management and internal control, as well as to explain material weaknesses identified and actions taken to address them.

It would be helpful for the guidance to identify what parts of this are existing guidance and which parts are new, to ensure firms approach the work required in a proportionate way.

Q17: Do you have any proposals regarding the definitional issues, e.g. what constitutes an effective risk management and internal controls system or a material weakness?

Q18: Are there any other areas in relation to risk management and internal controls which you would like to see covered in guidance?

We have no comments on Q17-Q18.

Q19: Do you agree that current Provision 30, which requires companies to state whether they are adopting a going concern basis of accounting, should be retained to keep this reporting together with reporting on prospects in the next Provision, and to achieve consistency across the Code for all companies (not just PIEs)?

We agree. Whilst firms will already be reporting on going concern, and FRC is encouraging all Code signatories to adopt the Resilience Statement which would incorporate this, where non-PIE firms elect not to do so, they should continue to include a going concern statement.

Q20: Do you agree that all Code companies should continue to report on their future prospects?

We agree.

Q21: Do you agree that the proposed revisions to the Code provide sufficient flexibility for non-PIE Code companies to report on their future prospects?

We consider that where a non-PIE is not statutorily obliged to produce an AAP or Resilience Statement, there needs to be continued coverage in the Code to retain the reporting requirements on viability and future prospects.

Q22: Do the proposed revisions strengthen the links between remuneration policy and corporate performance?

We consider the proposals do strengthen the link. For some AFM members, their mutual values mean that performance-related pay is either not adopted, or that the scale of reward is very low. We consider this itself offers safeguards that senior managers' interests are aligned with those of the business. For corporates, where the scale of remuneration and reward is much higher, the proposed changes offer valuable balance.

Q23: Do you agree that the proposed reporting changes around malus and clawback will result in an improvement in transparency?

We agree; for larger financial services firms much of this is already a requirement.

Q24: Do you agree with the proposed changes to Provisions 40 and 41?

We think the changes are largely helpful. However, we also note that the remuneration committee report is becoming longer and more complex, and this is making it more difficult for stakeholders to judge the appropriateness of pay awards and of pay arrangements.

Q25: Should the reference to pay gaps and pay ratios be removed, or strengthened?

We do not agree that the reference should be removed, as there is ever greater scrutiny of this area. Whilst the FRC may not wish to duplicate effort elsewhere, it would send out the wrong signal to remove it.

Q26: Are there any areas of the Code which you consider require amendment or additional guidance, in support of the Government's White Paper on artificial intelligence?

We would like to see a joined-up approach to regulation of the governance of AI. Whilst regulation of a sector should address most risks, the nature of AI systems mean there will need to be some hybrid approaches to ensuring the appropriate controls are in place.

The actors' strike in the US, in face of the threat of AI, should give us pause for thought. For example, could some of the roles reserved for directors, or the audit committee now, be better managed by AI? Ultimately, could a future evolution of AI replace the role of the NED?

However, in most respects, AI is part of the broader risk landscape firms operate in, and from a governance perspective, we would anticipate that firms would consider whether their exposures to Principal Risks should include AI risks in future, and to approach that in a similar light.