

# Corporate Governance Score

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## **Friends Provident Plc** **United Kingdom**

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<i>Overall Company Score (CGS)</i>	<i>CGS-8.4 (maximum CGS-10)</i>
<i>Component Scores:</i>	
Ownership structure and influence	9.0 (maximum 10)
Financial stakeholder rights and relations	8.7 (maximum 10)
Financial transparency and information disclosure	8.0 (maximum 10)
Board structure and process	8.0 (maximum 10)

### **Executive Summary**

Standard & Poor's has assigned Friends Provident plc, a FTSE 100 life assurer and asset manager, a Corporate Governance Score of 8.4, reflecting strong standards of corporate governance overall.

Friends Provident has been assigned a score of 9.0 for its ownership structure and influence of owners. As a recently demutualized company, Friends Provident is widely held and there are few potential conflicts of interest between owners and managers. Despite potential conflicts between the interests of policyholders and equity holders, Standard & Poor's has seen evidence that the Company manages these capably. There is good disclosure of directors' interests and adequate disclosure of institutional and other ownership of the Company's shares.

Friends Provident receives a score of 8.7 for the Financial Stakeholder Rights & Relations component of our analysis. Though the Company has conducted only one annual shareholder meeting since its demutualization, it maintains high standards for provision of shareholder meeting information and voting procedures. Directors are elected to three-year terms, in line with English Company Law and ownership rights are clearly stated and well-protected. A strongly defined dividend policy has not been articulated. Also, the Company has no structural defenses to a potential change in control, other than its own market capitalization.

Standard & Poor's has assigned Friends Provident a score of 8.0 for its financial transparency and information disclosure. While disclosure of industry-specific financial information is in line with other global and UK insurance companies, there are a number of additional disclosures that would clearly be welcomed by the market, reflecting a generally low level of understanding of the insurance industry and the complexity of its business. Non-financial disclosure is assessed strongly, though background information about some of the Company's directors could be more robust. Friends Provident does not report quarterly, and in general, access to disclosure is quite high. We also note the relatively high level of non-audit fees paid to the Company's outside auditor.

**For important information on Corporate Governance Scores, please see the last page of this report.**

Finally, Standard & Poor's has assigned Friends Provident a score of 8.0 for the board structure and process component of our analysis. The Friends Provident board of directors is composed of an equal number of executives and non-executives, including a non-executive chairman with a casting vote and highly independent audit and remuneration committees. The board has few outside directors with direct experience in the insurance industry, though the mix of skills and backgrounds is assessed as diverse. There are a few non-executive directors on the board with superficial conflicts of interest that do not make them appear to be fully independent of management or the Company, Standard & Poor's has found no evidence that challenges the Company's assessment of director independence. There is explicit consideration of director independence in the selection and appointment process, though the Company has not articulated its criteria in this area to the market. Finally, executive and director remuneration policy is assessed strongly, with attempts to connect executive pay with real increases in company performance and to restrict executive influence over their own pay. Some issues relating to executive succession and board evaluation have not been formalized.

### ***Company Profile***

Friends Provident plc (or "the Company") is a large financial services company based in the UK. Its two main businesses are providing life insurance and pension products through a network of independent financial advisers and direct marketing, and asset management, which it manages through its 67 percent ownership in separately listed ISIS Asset Management plc (formerly Friends Ivory & Sime), and which has over GBP 60 billion (\$95 billion) in assets under management.

Friends Provident is a member of the FTSE 100, the index of Britain's largest public companies. It has a corporate history that extends back to 1832, when the Company was founded to provide life insurance for members of the country's Quakers, also known as the Society of Friends. The Company retained its status as a mutual until 2001, when its members agreed to demutualize and list on the London Stock Exchange.

***Table 1: Summary Financial Information for Friends Provident plc (prepared according to UK GAAP)***

<b><i>GBPm Year End</i></b>	<b><i>2001</i></b>
Earned Premiums, net of reinsurance	1,479
Profit Before Tax	39
Profit attributable to shareholders	23
Retained profit	(37)
EPS	0.018
Shareholders' funds	32,717
Dividend per ordinary share	0.035

Financial information for years prior to 2001 relate to the Company's former status as an unlisted mutual and are not directly comparable.

## **Component 1: Ownership Structure and Influence**

**Component Score—9.0**

### **1.1 Transparency of Ownership**

**The Company shares are widely held. Shareholdings above 3 per cent are publicly disclosed.**

<b>Key Analytical Issues</b>	<b>Assessment</b>
Company shares are widely held.	Neutral
There is adequate disclosure of major shareholdings in public reports.	Positive
No clear public disclosure of shareholders by type.	Negative
Clear disclosure of directors' shareholdings.	Positive
Management is willing to discuss how shareholding structure relates to control environment.	Positive

Friends Provident (or "the Company") has a widely held share structure. Some of the Company's current shareholders were its policy-holders during their life as a mutual company, and many remain so. According to the latest information received from the Company, there are two substantial shareholdings identified (defined as a stake over three per cent, according to UK regulations) as of 31 December, 2002 (Achmea Pensioen – en Levensverzekeringen N.V. , a Dutch Life Insurer, at 4.97 percent and Banco Comercial Portugues, S.A. at 3.13 percent).

Currently, the Company does not disclose shareholders by type. Shareholdings of Directors (both executive and non-executive) as well as shares held under option schemes, are disclosed in annual reports.

### **1.2 Influence of Ownership and Other External Stakeholders**

**As the Company shares are widely held, there is no risk that might arise from presence of large block holder.**

<b>Key Analytical Issues</b>	<b>Assessment</b>
The majority of shares are widely held.	Neutral
There is no evidence of greater concentration of ownership.	Positive
Directors' shareholdings (both executive and non-executive) are too small to confer actual control.	Positive
There is no evidence of any group of shareholders exercising disproportionate powers.	Positive

Because the Company's shares are widely held, there is little reason to suspect that any one shareholder or group of shareholders has a disproportionate influence on management. Furthermore, there is little potential for conflict of interest between owners and managers. Directors' (executive and non-executive) shareholdings represent 0.02 per cent of total number of outstanding shares and are not large enough to enable them to have significant control over the Company through their holdings.

While not owners per se, policyholders are major stakeholders in Friends Provident and the need for the Company to balance the interests of policyholders and shareholders is an important one, in particular regarding bonus and dividend payouts. Our understanding is that the board of directors manages this issue on a case-by-case, annual basis rather than, for example, distributing investment surpluses of with profit funds on, for example, a fixed 90:10 basis in favor of policyholders as is often the case among UK insurers. As the Company demutualized only in 2001, it is too early to reach any strong conclusions regarding the Company's long-term treatment of policyholders vs. shareholders. However, it is important to note that to date we have seen no evidence that any real conflict of interest has arisen. While the market may welcome additional disclosure regarding the fair treatment of policyholders vis-a-vis shareholders (such as principles used in balancing the interests of policyholders and shareholders when it declares bonuses. for example), this is something few of Friends Provident's peers have undertaken. (See comments in Section 3.2, below). This is an issue that Standard & Poor's will continue to monitor.

## **Component 2: Financial Stakeholder Rights and Relations**

**Component Score—8.7**

### **2.1 Shareholder Voting & Meeting Procedures, Including Regularity, Ease of Access and Information on Shareholder Meetings**

**Though the Company has had only one shareholder meeting so far, Friends Provident has shown a commitment to shareholder democracy. The Company has supplied comprehensive and helpful information to shareholders in advance of the meeting. Voting procedures are fair and of a high standard.**

<b>Key Analytical Issues</b>	<b>Assessment</b>
Friends Provident informs shareholders of upcoming meetings sufficiently in advance (more than 30 days notice) to consider and execute their votes.	Positive
Notices of meeting are sent individually to beneficial owners and posted on the Company's website. Notices are comprehensive and provide enough information to reasonably make voting decisions.	Positive
The last meeting was convened in London, allowing the maximum number of shareholders to participate.	Positive
There is a clearly articulated set of voting procedures that is independently verified.	Positive
Shareholders may put forward shareholder proposals, nominate directors, and may convene shareholder meetings, in line with English law.	Positive
For those unable to attend meetings, voting procedures exist that are inexpensive, transparent, and simple to follow. Shareholders unable to attend meetings may vote by proxy, and may send instructions by mail.	Positive
Despite being allowed in the Company's Articles, shareholders may not vote by telephone or electronically.	Negative
Cumulative voting is not allowed.	Positive
All votes, whether cast at the meeting or in absentia, are given equal weight.	Positive

Friends Provident has held only one annual general meeting (AGM) of shareholders, as it demutualized and changed into a public company in 2001. Evidence from the 2001 meeting, however, does not suggest any problems and indicates a commitment to seeking active engagement from among its shareholders.

Registered shareholders are sent copies of the Notice of Annual General Meeting along with detailed explanatory notes for each voting item. Shareholders also receive the Company's annual report and financial statements along with the notice. As of the Company's 2003 AGM, shareholders will receive an enhanced board remuneration (compensation) report in compliance with recent changes in UK legislation that details remuneration policy and philosophy. Agendas and detailed voting instructions are also posted to the Company's website.

Voting at meetings is conducted via a combination of show of hands and voting by poll. In practice, the Company ensures polls are called for all items and votes of those present and also those voting by proxy and counted and announced together. We assess this positively, as voting by show of hands only does not give all votes equal weight by counting those present at the meeting in preference to the potentially many more votes sent by post. We note that cumulative voting is not allowed at Friends Provident, which we assess as positive: given its widely-held ownership structure, cumulative voting procedures are likely to elect directors representing specific shareholder interests, rather than the interests of the company and shareholders as a whole.

After each meeting, Friends Provident posts voting results for each resolution, though it does not post additional information, like presentations or transcripts of speeches. We note that electronic voting, while allowed in the Articles, is not yet provided for, though we understand that a facility for electronic voting will be introduced in time for the 2004 AGM.

## 2.2 Ownership Rights

**Ownership rights are clearly set out in the Company's Articles and other founding documents and are well-protected.**

<i>Key Analytical Issues</i>	<i>Assessment</i>
Secure ownership exists via a transparent and independent registrar system	Positive
Share structure is a mix of ordinary (common) shares that have clearly articulated rights. There are no different classes of ordinary shares.	Positive
Company Articles establish a principle of one share, one vote	Positive
Shareholders enjoy preemptive rights over issuances of new shares.	Positive
There are no supermajority requirements that interfere with shareholders' rights to elect directors or ratify corporate actions.	Positive
Shareholders elect individual directors once every three years.	Slight Negative
There is no clearly articulated dividend policy	Negative

Rights attached to Friends Provident shares are secure and fully transferable. All ordinary (common) shares are equal and there are no multiple classes of ordinary shares. Owners of ordinary shares have the right to vote, to receive dividend payments, put forward shareholder proposals, nominations for the board, and, in the case of liquidation of the Company, to receive proportional payment in turn.

Voting rights are extensive and articulated by the UK's 1985 Companies Act and the Financial Service Authority's Listing Authority. Shareholders vote on all major company decisions including the election and removal of directors, appointment of and payment of fees to the auditors, dividends, compensation (share incentive) plans, Article amendments, share issuance authorities, and major acquisitions, disposals, and related party transactions over a certain size. The Company has also positively allowed shareholders to vote on at least one issue not required by law until this year – the directors' remuneration report.

Friends has disclosed that it intends to pursue a progressive dividend policy, and in 2001 increased the notional per share amount of dividends by six percent over the previous year. It has not gone beyond this, however, and articulated to the market what it means by progressive, or identified a target payout ratio or level of net profit to distribute.

Though Friends Provident has a classified board (one-third of all directors place themselves before shareholders for reelection each year), this is universal among British companies and is a requirement under English company law. Low thresholds for shareholders wishing to call a special meeting (5 percent of shares outstanding or 100 shareholders acting together) lessen the impact this practice might normally have on shareholders' ability to change the board, though shareholders do not enjoy the right to vote on each director each year.

The Company has selected Computershare as its independent share registrar, which provides for secure ownership registration and vote collection. A competitive tender process is used to select the registrars.

## 2.3 Takeover Defenses

**Friends Provident has no defenses against a possible takeover, other than its own market capitalization.**

<i>Key Analytical Issues</i>	<i>Assessment</i>
Friends Provident remains open to a potentially value-enhancing bid for its shares. The Company has no takeover defenses, structural or implicit.	Positive
There are few concerns about governmental or regulatory influence in the context of a bid.	Positive

Friends Provident has no takeover defenses. As a UK-listed company, it is subject to the Takeover Panel and the rules of the London City Code on Takeovers and Mergers that supports equal treatment for shareholders during takeovers and sending bids to shareholders for approval, rather than allowing directors themselves to negotiate among bidders. As explained above in Section 2.2, the Company's classified board structure does not represent a significant hurdle to a successful bid as it would in the United States.

### **Component 3: Financial Transparency and Information Disclosure**

Component Score—8.0

#### **3.1 Quality and Content of Public Disclosure**

**Quality and content of information disclosed by the Company is of high standard. Disclosure of industry-specific financial information is in line with other global and UK insurance companies.**

Key Analytical Issues	Assessment
Financial statements are prepared according to UK GAAP, which is broadly in line with IAS.	Positive
There is adequate non-financial disclosure.	Positive
Public disclosure regarding shareholders' rights are detailed and clearly presented.	Positive
Corporate records and records of shareholders meetings are well-maintained.	Positive
There is comprehensive disclosure of related party transactions in the notes to financial statements.	Positive
The Company includes a corporate governance review as a part of its annual report.	Positive
There is little additional disclosure that extends beyond than what is required by law or regulation.	Negative

As a recently de-mutualized (July, 2001) insurance company listed on the London Stock Exchange, Friends Provident's public disclosure is largely governed by the requirements of its market regulator – the Financial Service Authority (FSA) and by UK Company Law (The Companies Act 1985). The Company fully complies with these disclosure requirements. However, we believe that in certain aspects greater disclosure about some issues, which would involve going beyond what is required by law and/or regulation, would further enhance the Company's transparency and be welcomed by the market. Areas where more information would likely be most welcome include: the decision-making process on bonus payouts to policyholders and management of the potential conflicts between different groups of policyholders as well as policyholders and shareholders. The Company has informed us that they do not have any orphan estates as these were distributed to policyholders and/or shareholders during the demutualization process. Nevertheless, given interest in the market, it would be positive if the Company were to disclose the absence of these funds. While Friends Provident is hardly alone in not making these disclosures, these areas have been mentioned by market participants as disclosures that would improve the transparency of the insurance industry in general – a sector that is widely considered to be opaque and challenging to analyze.

Friends Provident's disclosure of non-financial information is reasonably detailed and covers information about shareholder rights as well as investor-specific information (AGM, analyst presentations, corporate governance reports, etc). The Company's disclosure also emphasizes its strong commitment to environmental and corporate social responsibility. Friends Provident is a member of the relatively recent FTSE4GOOD index, which tracks socially responsible companies.

Disclosure regarding executive and board member remuneration is very strong on a global basis and is included in the annual report as a separate section. It includes a clear breakdown of directors' remuneration packages as well as details of outstanding share options. We note that there is somewhat limited disclosure of the professional background of directors as well as details of the other boards that they sit on (UK Companies House and listing rules allow companies wide discretion to disclose directorships at non-quoted companies and historical details).

A number of insurance companies, including Friends Provident, have received criticism in the past for the lack of transparency associated with the use of virtual capital reinsurance, a type of reinsurance that temporarily removes liabilities from the balance sheet, benefiting companies' free asset ratio. Similar arrangements have been the focus of regulatory debate in the UK for some time, while different aspects of these arrangements have become a concern for the insurance industry as a whole. The concerns, as expressed by the FSA, arise from the fact that some types of financial engineering (notably financial reinsurance) have features that can make them difficult to control as well as to regulate. These are mostly specially tailored long-term agreements accompanied by non-standard documentation for which there is no regulatory requirement to

disclose in the UK. Friends Provident does disclose that it maintains a reinsurance program, but has disclosed little about how risks have or have not been transferred to the reinsurer including, for example, the presence of side letters to the reinsurance agreement.

Recognizing that growing holes exist in insurance accounting, and in particular in the treatment of financial reinsurance, the International Accounting Standards Board (IASB) has agreed to look into reforming and tightening some existing insurance accounting practices. Furthermore, the FSA, as the industry's main regulator in the UK, and aware of the opacity and risks at some insurance companies, has been working since late 2001 on updating future regulations of insurance companies. Work is still ongoing; the most recent progress report was published in October, 2002. We fully expect Friends Provident to comply with these regulations once they are released.

Our assessment of quality and content of the Company's disclosure is currently not greatly constrained by the general criticism facing the insurance industry as a whole, as this is at least partly due to the regulatory environment. Despite this, we believe that in a number of areas the Company has decided not to provide disclosure beyond that required by law, whether or not the market would welcome such disclosure. We also note that Friends Provident is a newly listed company (it listed in July, 2001) and in some ways this may be expected as it learns more about investor expectations. Standard & Poor's believes that more disclosures will be forthcoming and will monitor this in the future.

### 3.2 Timing of, and Access to, Public Disclosure

Key Analytical Issues	Assessment
There is timely communication with shareholders.	Positive
Shareholders and potential investors are provided with special reports, such as analyst presentations.	Positive
The Company reports are filed on time.	Positive
Public information is available from the Company's headquarters.	Positive

The Company's timing and access to public disclosure is very strong. Apart from compliance with content and timing requirements of the London Stock Exchange and other regulatory requirements, Friends Provident maintain a highly informative web site which presents a useful and comprehensive source of information and is easy to navigate.

In addition to the expected financial results, overview and calendar, the investor section of Friends Provident's website provides shareholders with a number of online services allowing for speedy receipt of information regarding dividends, taxation of dividends, buying and selling of shares, etc. Information regarding the most recent AGM as well as the date of the next one is also posted. It is positive that the Company provides their shareholders and potential investors with an opportunity to review voting results and AGM notices. Small concerns include the Company's Articles of Association, (available only upon request or through a third-party distributor), and the absence of quarterly reporting which, while controversial because of how some investors use such reporting, Standard & Poor's nonetheless considers to add substantially to increased transparency.

The Company sees itself as the leader in the field of socially responsible investing and their web site reflects this. It provides a detailed explanation of their approach to socially responsible investment (a strict 'screened' ethical approach called Stewardship and an 'engagement only' approach called **reo**<sup>®</sup>, or Responsible Engagement Overlay).

### 3.3 Auditor Independence and Audit Process

Key Analytical Issues	Assessment
The outside auditors are experienced and reputable.	Positive
There is a clear tender procedure for appointment of external auditors.	Positive
Non-audit fees are substantially higher than audit fees. (See comments).	Negative
There is an Audit and Compliance Committee composed entirely of independent directors.	Positive
The Audit and Compliance Committee owns the relationship with the outside auditors	Positive
The Audit and Compliance Committee is directly involved in risk management.	Positive

The Company has a long relationship with its external auditor PricewaterhouseCoopers (PwC), which goes back to its time as a mutual. Appointment of the external auditor is via a clearly established tender procedure and this decision is reviewed every year. The Audit and Compliance Committee plays an important role in this process, as it is the committee's responsibility to recommend to the board of directors the hiring and firing of the auditor, to approve audit fees as well as any other question regarding resignation or dismissal. The committee has a clearly articulated charter that outlines its role and responsibilities. All of the above-mentioned issues are included in the charter, which was published in March, 2003.

The Audit and Compliance Committee has three members and they meet on average four times a year. In line with local and international codes of best practice, Friends Provident's audit committee is composed entirely of independent, non-executive board members, at least one of whom meets financial expertise recommendations. The committee manages the relationship with the external auditor and external auditors attend each of the committee meetings, and are frequently given an opportunity to meet alone with the non-executives.

In addition to its audit work, PwC provides the Company with a number of other services. Fees for this work are presented in the table below:

Fees	2001 (£ million)	As % of Total
<b>Audit</b>	<b>0.6</b>	<b>11.3</b>
Non-audit Work	4.7	88.7
Total	5.3	100.0

Source: 2001 Annual Report

While non-audit fees for 2001 were substantially higher than audit fees, it is important to note that the majority of the fees (£4.5 million or 95.6 percent of total non-audit fees) were for work on the Company's demutualization and listing process. That the Company has used its auditor, PwC, for this work is fairly common and, in the case of Friends Provident, the Company had recently completed a tender and reappointment procedure with respect to PwC as their outside audit firm. While Standard & Poor's found no evidence that challenges the Company's and the Audit Committee's assessment of auditor independence, outside confidence in the process may rely on both the perception of independence in appearance as well as in fact.

In connection with this we note that in 2002, the Company developed a Group-wide non-audit policy for its outside auditor. A decision was made not to impose an outright ban on the audit firm from providing non-audit services, but the Company did agree to more defined guidelines. These include: Audit Committee approval to allow the outside auditor to complete non-audit work, a new tender requirement for all non-audit work above £50,000. While not strictly in line with recent proposals about audit vs. non-audit work (many have recommended that auditors should not provide any service to the Company that is not directly connected to the audit itself), Standard & Poor's believes that the Company has taken a pragmatic approach and that potential conflicts of interest are managed capably by the above policy.

Risk management and internal control procedures are clearly articulated in the Company's policy on risk management, described in more detail below. The Audit and Compliance Committee plays an important and active role in the process of identifying, managing and monitoring risks associated with the business. Details of the Internal Controls and Risk Management policies are disclosed in the Corporate Governance Report (part of the annual report). Standard & Poor's assesses as positive the fact that Audit and Compliance Committee can appoint an independent external person or company to provide them with advice or assessment on issues that they feel necessary. Recent recommendation on changes in the insurance industry have included proposals to appoint independent actuaries which would provide an independent assessment of the policies and business practices that insurance companies use. Currently, this role has been fulfilled by internal actuaries, appointed by management. The appointment by the Company of independent actuaries, not beholden to management, is something that Standard & Poor's believes is a possibility over the medium to long-term.

## **Component 4: Board Structure and Process**

**Component Score—8.0**

### **4.1 Board Structure & Composition**

**Friends maintains a board with an equal number of non-executive and executive directors, a separate Chairman and CEO, and highly independent control committees.**

<b>Key Analytical Issues</b>	<b>Assessment</b>
Half of directors are non-employed and all but two are independent by measures of appearance alone.	Positive
CEO and Chairman positions are separate. The Chairman is non-employed.	Neutral
There are Audit, Remuneration and Nomination Committees, all of which are highly independent	Positive
At 12 members, the size of the board appears neither large nor small.	Positive

### **Full Board and Major Board Committees (proposed to 2003 AGM)**

	<b>Executive</b>	<b>Non-executive</b>
Full Board	6	6
Audit Committee	0	3
Remuneration Committee	0	3
Nomination Committee	1	2

Friends Provident's board has an equal number of executive and non-executive members, the majority of which can be assessed as independent by measures of appearance alone (the UK's Combined Code on corporate governance for example recommends only one third of the board be independent, while the more recent Higgs Report on Non-Executives in the UK recommends at least half be independent). This balance reflects current board practice in the UK, where, broadly, the board is seen as a unified body overseeing the operations of the company in cooperation, rather than as a group of outsiders whose main role is overseeing and policing the top executives. (We note that, despite the equal numbers of executives and non-executives, the non-executive Chairman has a casting vote.) The board also includes separate Chairman and CEO positions, independent board committees (with the exception of the nomination committee, of which the CEO is a member) and has identified a senior independent director.

Directors represent a diversity of backgrounds and skills and come from industry, finance, politics and the regulatory arena, though we note that no outside director has direct experience in the insurance industry. The only area where Friends Provident does not comply with the Combined Code is that of director contracts, where the finance director has a two-year rolling contract instead of the one-year contract recommended by the Code. (see Section 4.4 below).

## 4.2 Role and Effectiveness of the Board

<i>Key Analytical Issues</i>	<i>Assessment</i>
The board has articulated for itself a set of matters reserved for its decision	Positive
The board has an appropriate mix of skills and experience for its industry	Positive
Board workload has been increasing over the last two years as it tackles more and varied issues	Mixed
The Company Secretary plays a large supporting role for the board and the Company as a whole	Positive
The Chairman plays a large role on and off the board	Neutral
Non-executives do not appear to have direct experience in the insurance industry	Negative

The Friends Provident board appears to have largely completed its transition from a mutual board to that of a PLC, with its ingrained spirit of independence and more aggressive ethos. Our interviews with longer-serving board members indicate that the mutual board had been acting much like that of a PLC for some time before the demutualization was finalized. In general, our review of the board and committee minutes and papers, in addition to our meetings with seven of the 12 board members (including three of the six non-executives), support an assessment of the board as an effective monitor of management and as a body deeply engaged in providing strategic leadership to the Company.

Friends Provident's board met an average of once a month in 2002, typically with an ambitious agenda. Board discussions appear to be open and uninhibited, if perhaps a bit formal, particularly in the elements relating to board process. Equally, such attention to detail has positive practical consequences; it is an additional check against impropriety and would appear to reduce the Company's headline risk. Standard and Poor's review of board minutes indicated that there have been several quite active board discussions, including a debate about whether to pursue demutualization itself back in 2001. Board members receive board papers more than a few days before meetings and always including a weekend, allowing directors to be well briefed in advance of meetings. The increasing amount of material sent to the board and its committees, however, may present a challenge for the board, especially those non-executives with significant external commitments, carrying a risk of overload. Highlighting the issue is the fact that the board's increasing workload was mentioned by almost every director Standard & Poor's interviewed.

We note that Friends Provident has followed the recommendation of the UK's Combined Code on Corporate Governance and appoint a non-executive Chairman. As a general rule, Standard & Poor's is agnostic as to the relative merits of a split Chairman and CEO, believing that there are potential risks to board effectiveness and oversight under both systems (the risks of a dominant CEO are well known; split CEO/chairmen positions are themselves difficult to get right: the arrangement can be ineffective if the personalities are too close or can lead to competing power centers on the board if they do not get along or have different agendas). In Friends Provident's case, the Chairman (who took up his current role one year after Keith Satchell was appointed CEO), does play a large role on and off the board, though concerns are lessened by the formal board procedures in place and a clear articulation of roles between the CEO and the Chairman. Moreover, Standard & Poor's has seen evidence of a positive working relationship between the two leaders, supported by strong personalities among the other board members, both executive and non-executive, and by frequent, informal discussions and meetings involving the Chairman and the other non-executives (See below this section) All of this reduces the potential for competing centers of power to develop on the board.

For its part, the board appears quite happy with the other side of the equation and many non-executives Standard & Poor's met with expressed explicit confidence in the CEO and his leadership. He appears to be particularly respected for his communications style, both to the board and the wider company. We note that the CEO sits on the boards of three other public companies in addition to his Deputy Chairmanship of the Association of British Insurers (an industry association) and his involvement in the Association's Life Insurance Committee. These commitments exceed by two the recommendation of the Higgs Report on non-executives. Despite this fact, Standard & Poor's could find no evidence that this has hurt his effectiveness as CEO and did not hear any concerns to this effect from the non-

executives. In any case, the Friends Provident non-executives, as a procedural rule, must approve all outside directorships of the executive directors.

As mentioned above, it is the informal elements of the Friends Provident board that appear to be among its largest strengths. Non-executives meet informally with each other throughout the year (without executives present), are expected to occasionally visit various sites of the Company's operations, and attend one or two board retreats each year, where strategic and other long-term issues are addressed in detail. There is also a semi-formal program of training offered for new directors. Finally, the most recent change in CEO, which occurred in 1997, was a relatively smooth process, and illustrates the institutional strength of the board as a collective.

Supporting much of the board's effectiveness is the company secretary who, as reflected by his seniority as well as his board seat, plays both an unusually large and positive role at the Company. Heading up the legal, risk-management, human resources and investor relations functions, in addition to providing logistical support to the board, the company secretary at Friends Provident is assessed as underpinning much of the board's functional effectiveness. In a more subtle way, he may act as a kind of conscience of the board, reminding directors of their fiduciary duties and advising on issues like disclosure and governance best practice. We note as a small concern that succession for the company secretary will need to be managed in the medium term given the scope of the role and his seniority.

#### **4.3 Role and Independence of Outside Directors**

***Friends Provident directors demonstrate a commitment to the independence of the board as a body. At the same time, there are a number of superficial conflicts on the board that may affect outside confidence in perceived independence.***

<b><i>Key Analytical Issues</i></b>	<b><i>Assessment</i></b>
The director selection process includes explicit consideration of independence, though no written definition of independence has been set.	Positive
Non-executives meet independently of management.	Positive
Existing external directorships held by board members do not now appear to interfere with the quality of their involvement.	Neutral
While relationships that external directors have with the Company are limited, there are a few superficial conflicts that may affect perceived independence.	Negative

Although Friends Provident's board has not established its own clear principles relating to director independence, the Company does strive to meet market expectations in this area, including meeting the recommendations for director independence as set out by the UK's Combined Code of Corporate Governance. The board includes six non-executives, including the outside Chairman and Alison Carnwath, the most-recently appointed director. Of the six non-executive directors, two can be identified as having conflicts of interest that may affect their perceived independence: one, the Chairman, sits as a non-executive director on the main board of Merrill Lynch & Co. Inc, which has acted as one of the Company's brokers and investment banker for some time and which was also the Company's lead underwriter in its demutualization. He also sits on the board of Benchmark Group PLC with another FP executive, reflecting FP's 34.7 percent investment in this company. The other, one of the more recently appointed directors, sits on the board of a subsidiary-venture capital fund of ISIS, itself a Friends Provident subsidiary, and will receive as an incentive fee a proportion of the fund's carried interest at the end of a 10-year investment period.

The Company has taken steps to mitigate conflicts of interest in both of these cases (the Chairman removes himself from all discussions concerning compensation of Merrill Lynch, for example), and, for its part, the Company has disclosed that it considers each of its six non-executive directors as independent in all material respects. We also note that two other non-executive directors receive fees for serving on Friends Provident subsidiary boards or on investment oversight committees for the larger group. While Standard & Poor's found no evidence that challenges the Company's assessment of director independence, outside confidence in the Company's governance may rely on both the perception of independence in appearance as well as in fact. To this end, we also note that the Company has not articulated to the market criteria for director selection and director independence.

Standard & Poor's has seen evidence that many of the Friends Provident outside directors are active and engaged, and that they provide a strong and credible basis for monitoring management. Based on our interviews and access to board minutes, the non-executives played key and distinct roles during the demutualization process, a fact that is assessed positively. Moreover, Standard & Poor's has seen evidence that the board has on occasion taken advantage of the ability to seek outside opinion from consultants or advisers when it was needed.

Worries that several directors sit on a large number of other boards are mitigated in practice. The Chairman, for example, sits on six other boards of listed companies (more, including non-public companies which do not need to be disclosed), including a time-intensive commitment to the main board of Merrill Lynch & Co. Inc. In practice, however, he maintains offices at Friends Provident, where he is found on most weekdays, and Standard & Poor's has seen clear evidence of his day-to-day involvement and significant influence at the Company, especially in areas of board functioning. It is for reasons like these that bright-line rules about the number of outside directorships are generally unhelpful in assessing governance. While not a concern with regard to the Chairman, we note that other directors may have significant external commitments that may not be a problem at the moment, but that may raise concerns were there to be a situation that demanded much more time at another company.

#### **4.4 Board and Executive Compensation, Evaluation and Succession Policies**

***Compensation policies at Friends Provident are transparent and well-defined. The Company has taken specific measures to connect pay to broad and long-term measures of performance.***

<b>Key Analytical Issues</b>	<b>Assessment</b>
The Company has made efforts to link executive pay with increases in broad measures of performance.	Positive
The process by which pay is set is independent from executive influence.	Positive
The Company has clearly articulated compensation practices and philosophy, which are followed in practice.	Positive
Potential dilution to shareholders from option exercises is modest.	Positive
The Company is balancing the goals of connecting pay with performance and transparency of pay. See analysis.	Mixed.
Some issues relating to succession have not been formalized.	Negative
Board and executive evaluation practices are somewhat ad hoc in nature	Negative

Friends Provident has a clearly articulated compensation policy that has been disclosed in its reports and accounts for some time. Notably, it has sought a shareholder vote on its compensation practices since its first shareholder meeting in 2001, despite the fact that it was under no legal obligation to do so at the time. The board's remuneration committee is quite active, meeting six times in 2002 and with plans to do the same in 2003.

The Company maintains strong disclosure about issues of executive remuneration in general, publishing a thoughtful and detailed Remuneration Report, in line with new regulatory requirements, in its 2003 Annual Report and Accounts. We note that while details of Howard Carter's remuneration are decided and paid by the ISIS board they are disclosed in both ISIS and Friends Provident reports.

Base salaries are pegged to the median level of pay for similar positions at FTSE 100 and 250 companies. Incentive pay is composed of an annual bonus and share incentive schemes that pay out both options and restricted stock. The annual bonus pays out up to 100 percent of base salary, connected to the achievement of personal goals set by the remuneration committee as well as growth in achieved operating profit. Several executives have tailored performance conditions, with smaller portions of their bonus connected either to growth in EPS at ISIS or to measures of corporate social responsibility. The Company maintains an executive share option scheme (ESOS), and an Executive Long Term Incentive Plan (LTIP), a type of restricted stock plan. Under both plans, performance criteria are challenging – growth in total shareholder return (TSR) measured against its index for the LTIP and the amount that Return on Embedded Value (ROEV) exceeds the discount rate used – both measured over a three-year performance period. These conditions show that the Company has made real efforts to link pay with performance without focusing all awards on simple increases in share price.

Dilution from stock-based compensation is modest. Approximately 0.06 percent of outstanding shares are under option or provisionally granted to five executive directors. When all employees with awards are considered, the total is still less than one percent. Moreover, most of the options are underwater due to the Company's lowered share price and are unlikely to be exercised soon. These levels of dilution are low compared to others in the financial services industry in the UK and elsewhere, particularly in the US, where levels of expected dilution can far exceed five and ten percent. The dilutive impact of equity-linked compensation has also been minimized by the separate listing of Friends Provident's asset management subsidiary, which can provide targeted incentives to its own asset managers via options over ISIS shares.

While we have assessed the Company's attempts to connect pay more closely with performance, doing so has in one area affected transparency of the process. While using Return on Embedded Value as a measure for the LTIP payouts may more closely align executives' performance with company results, embedded value remains difficult to determine for the average investor and as such is not strongly transparent as a performance measure. In a similar way, Friends Provident's rolling limits over shares that may be used under stock compensation plans (for example, 10 percent of shares over any ten year period) cannot produce an accurate estimate of potential shares reserved for these plans, at least without an assumption of growth in shares outstanding. In this way, Friends Provident is attempting to balance the strong values of pay for performance and minimizing dilution with the value of increased transparency.

We note two smaller concerns about executive compensation policies at the Company. Despite a recommendation from the UK's governance code, Friends Provident has maintained a two-year rolling employment contract with its CFO. The contract was originally signed with a predecessor company, which terms Friends Provident has agreed to honor. While a shorter term would certainly reduce the Company's liability in the event of his departure, Standard & Poor's believes the amount in question is not material, particularly given the importance of the CFO's role. Like the number of outside directorships, Standard & Poor's does not find bright line rules about director pay particularly helpful in analyzing governance practice. The second concern is more salient: while we do believe the Company has taken steps to minimize the influence of directors on their own pay, this independence may be challenging to maintain if the board continues to have remuneration consultants selected by executives rather than the independent members of the remuneration committee.

Going forward, we believe that the board is likely to focus more attention on issues of executive evaluation and succession. CEO evaluations are likely to become more formalized and an evaluation of the board as a whole may be considered. The board is also expected to develop more robust and formalized succession planning for senior executives.

## Corporate Governance Scores

A Corporate Governance Score ('CGS') reflects Standard & Poor's assessment of a company's corporate governance practices and policies and the extent to which these serve the interests of the company's financial stakeholders, with an emphasis on shareholders' interests. These governance practices and policies are measured against Standard & Poor's corporate governance scoring methodology, which is based on a synthesis of international codes, governance best practices and guidelines of good governance practice.

Companies with the same score have, in the opinion of Standard & Poor's, similar company specific governance processes and practices overall, irrespective of the country of domicile. The scores do not address specific legal, regulatory and market environments, and the extent to which these support or hinder governance at the company level, a factor which may affect the overall assessment of the governance risks associated with an individual company (see below 'Country Factors').

### ***A CGS is articulated on a scale of CGS 1 (lowest) to CGS 10 (highest).***

***CGS 10 and CGS 9***—a company that, in Standard & Poor's opinion, has ***very strong*** corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, few weaknesses in any of the major areas of governance analysis.

***CGS 8 and CGS 7***—a company that, in Standard & Poor's opinion, has ***strong*** corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, some weaknesses in certain of the major areas of governance analysis.

***CGS 6 and CGS 5***—a company that, in Standard & Poor's opinion, has ***moderate*** corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, weaknesses in several of the major areas of governance analysis.

***CGS 4 and CGS 3***—a company that, in Standard & Poor's opinion, has ***weak*** corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, significant weaknesses in a number of the major areas of governance analysis.

***CGS 2 and CGS 1***—a company that, in Standard & Poor's opinion, has ***very weak*** corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, significant weaknesses in most of the major areas of analysis.

### ***GovernanceWatch***

A 'GovernanceWatch' designation may be used to highlight the fact that identifiable governance events and short-term trends have caused a CGS to be placed on review. GovernanceWatch does not mean that a change to the CGS is inevitable. GovernanceWatch is not intended to include all CGSs under review, and changes to the CGS may occur without the CGS having first appeared on GovernanceWatch.

### ***Country Factors***

Although Standard & Poor's publishes country governance analyses from time to time, it is important to note that Standard & Poor's does not currently score individual countries. However, consideration of a country's legal, regulatory and market environment is an important element in the overall analysis of the risks associated with the governance practices of an individual company. For example two companies with the same Company Scores, but domiciled in countries with contrasting legal, regulatory and market standards, present different risk profiles should their governance practices deteriorate i.e. in the event of deterioration in a specific company's governance standards, investors and stakeholders are likely to receive better protection in a country with stronger and better enforced laws and regulations. However, in Standard & Poor's opinion, companies with high corporate governance scores have less governance related risk than companies with low scores, irrespective of the country of domicile.

For a full explanation of Standard & Poor's criteria for measuring corporate governance standards, please refer to the latest edition of "***Corporate Governance—Criteria & Methodology***".

#### ***Important Note***

A CGS is based on current information provided to Standard & Poor's by the company, its officers and any other sources Standard & Poor's considers reliable. A CGS is neither an audit nor a forensic investigation of governance practices. Standard & Poor's may rely on audited information and other information provided by the company for the purpose of the governance analysis. A CGS is neither a credit rating nor a recommendation to purchase, sell or hold any interest in a company, as it does not comment on market price or suitability for a particular investor. Scores may also be changed, suspended or withdrawn as a result of changes in, or unavailability of such information.

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