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Dear Jason and Leonor,

**AFM Response to FCA consultation CP14/23, Restrictions on the retail distribution of regulatory capital instruments**

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:
  - Respond to the consultation proposals; and
  - Highlight the need to consider other forms of mutual share capital in finalising the rules, such as that being developed via the Mutuals' Deferred Shares Bill.
2. The Association of Financial Mutuals (AFM) represents 52 member companies, most of which are owned by their customers. Between them, AFM members manage the savings, pensions, protection and healthcare needs of over 20 million people in the UK and Ireland, and have total funds under management of over £100 billion. 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. FCA has a statutory obligation to consider the specific consequences for mutuals of any new regulation.
3. We are not aware that any of our members have in the past, or plan in the future to issue Contingent Convertible securities, and we are not responding to this section of the consultation. The proposals in chapter 3 though will be of significant interest to our members, assuming that the Mutuals' Deferred Shares Bill completes its

parliamentary passage, and our members are in due course able to offer vehicles similar to building society core capital deferred shares (CCDS)<sup>1</sup>.

4. In our submissions to government on the value and potential use of a new form of mutual share for mutual insurers and friendly societies, we have stressed a strong desire by our members to be able to offer such products to their existing retail members. The temporary restrictions for CoCos would prevent this, so we welcome the proposals to allow retail consumers, in certain circumstances to purchase these shares.
5. Where the government has made a commitment to 'promote diversity and support mutuals', it has also required the FCA to help facilitate competition. We consider that the current capital rules strongly disadvantage the mutual business model, and that as a result consumers have less choice and some, particularly the less affluent, have limited access to some products. It is also apparent from AFM research that where consumers continue to mistrust PLC banks and other financial providers, the reputation of mutuals remains strong; therefore capital constraints on mutuals, which inhibit their growth, also subdue supply and demand in the market as a whole.
6. As we have stated to government, whereas retail depositors of a building society can ordinarily buy further into their society by increasing the amount of their investment, this is often not possible for policyholders of a mutual insurer, either because there is an investment limit on the product, or a restriction on the cover that can be purchased, or because the product is no longer actively marketed. The financial crisis demonstrated that consumers were much more likely to trust mutuals than PLCs, and we anticipate on this basis that retail investors would be interested in purchasing shares in a mutual to which they are already a member. For smaller mutuals in particular it is more likely that issuing shares purchased by their members would provide new capital at a more proportionate cost than via institutional investors.
7. We agree that it is vital that consumers should be fully aware of the nature of the investment and its consequences before investing, and accept that some kind of test should be applied. It is not clear from the FCA paper how they have arrived at the threshold figures proposed though: the 5% (of investable assets) figure for example seems somewhat arbitrary. Furthermore, whilst the safeguards proposed reflect the regulator's concern that retail depositors in a building society might not appreciate the different risks involved in a CCDS, in most

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<sup>1</sup> For more information on the Bill, see: <http://www.mutuo.co.uk/bill/>

cases such as an investor will have experience of investing in other medium elsewhere. In any event, we do not see that as being of relevance to insurers, where investment policyholders or pension holders are usually exposed to equity investment, and are accustomed to their investment having limited liquidity.

8. We have provided responses to the questions posed in chapter 3 of the consultation, on the expectation that the Mutuals' Deferred Shares Bill is passed as currently proposed, and that therefore the proposed FCA rules will apply equally in the future to these shares as to building society CCDS. We urge FCA if possible, to adopt a similar principal in its final rules. We would be pleased to discuss further any of the issues raised by our response.

Yours sincerely,



Chief Executive  
Association of Financial Mutuals

## Answers to selected questions

*Q 8. Do you believe we should subject all mutual society shares to the same distribution restrictions as CoCos or do you consider there is a need to allow the wider retail distribution of mutual society shares?*

We do not believe that mutual shares should be subject to the same distribution restrictions as CoCos, and agree with the analysis in the paper about the merits of facilitating a retail market for mutual shares.

We see mutual shares as having more in common with the characteristics of crowdfunding than with CoCos, and believe the retail market should be aligned with PS14/4 more than with the rules proposed for CoCos.

*Q 9. Alternatively, do you believe applying to CoCos the same approach as proposed for mutual society shares would achieve an appropriate degree of consumer protection?*

We think the risks in CoCos are different to mutual shares and are greater, and the approach to consumer protection should therefore be different. We would be wary of reputational risk to mutual shares of being seen to be similar to CoCos as this would affect the views of potential investors.

*Q 10. Do you believe secondary market transactions should be subject to the same rules as primary market sales?*

No we do not.

*Q 11. Do you agree with the proposed basis on which mutual society shares could be distributed in the retail market?*

We agree with the general approach of enabling distribution to certified sophisticated investors and high-net worth investors, as well as professional and eligible counterparty clients without restriction. We also agree with the nature of the risk warning to ordinary retail clients, as stated in paragraph 3.18, and accept the need for an investment limit.

However, the proposal that the limit of investment should be 5% of a potential investors net investable assets appears arbitrary. In paragraph 3.27 of the consultation PRA explains how it has arrived at this figure, and why it believes there should be a different figure for mutual shares than for investment-based crowdfunding. The argument appears to centre on how the products are promoted, citing the possibility that mutuals will be more likely to promote the product to *'inexperienced investors who may passively receive promotional communications'*.

We disagree with this analysis: mutuals would expect to actively market shares to their current membership base, for whom they have developed a range of skills and techniques, for understanding their investment experiences and propensities. The fact that crowdfunders attract relatively knowledgeable investors is not a result of targeted

promotions (as judged by the significant increase in adverts across the Underground), but the nature of the investment. We consider that the limit should be aligned with that for crowdfunding at 10%.

This is supported by the use of such capital instruments by mutuals in other parts of the world, where the active promotion to members has been a valuable and important part of the process. A report by Mutuo earlier in 2014 included examples from Rabobank in The Netherlands, and Desjardins in Canada<sup>2</sup>. The latter in particular has issued \$1.5 billion in the last two years, most of which has been purchased by retail investors without the need for advice.

The draft definition of 'mutual society share' is written purely in the assumption that these shares are provided by building societies are designed to fit the directives and rules for deposit-takers. Clearly we would want to see the rules being capable of expansion to accord with the requirements of Solvency 2 and the needs of mutual insurers and friendly societies; assuming legislation is made to enable that we expect FCA would need to undertake a thorough revision of the draft rules.

*Q 12. Do you agree with our proposal to require firms to conduct an appropriateness test in relation to non-advised sales of mutual society shares to ordinary retail investors even if they are not carrying on MiFID or equivalent third country business?*

We think this is a valuable safeguard, and that a consistent approach is warranted.

*Q 13. Do you agree with our proposal to require records to be kept for each sale of mutual society shares to retail clients?*

We agree.

*Q 14. Do you agree with our proposal to require the compliance department to confirm the compliance of each mutual society share sale?*

We agree.

*Q 15. Do you agree that the person responsible for compliance function oversight in the firm must review the approval process for compliance confirmation on at least an annual basis?*

In many cases, mutual shares will not be traded on an annual basis: where they are issued as an alternative to a debt issue, it may be that the investment window is relatively narrow and that the mutual would only plan to issue mutual shares rarely.

We would suggest that the compliance function should review the approval process each time a new share issue is provided, or annually if they are offered on an open basis.

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<sup>2</sup> <http://www.mutuo.co.uk/wp-content/uploads/2013/11/Raising-New-Capital-in-Mutuals.pdf>

*Q 16. Do you have any comments on the impact of our proposals on existing investors?*

This would not apply to our members, so we are not offering any comments.

*Q 17. Do you have any comments on our analysis of the market for CoCos and mutual society shares or further information about it?*

We consider that the market for mutual shares will grow significantly in the future, particularly if the legislation is approved to permit them for mutual insurers and friendly societies. Treasury has been working on an impact assessment for the Mutual Deferred Shares Bill, which assesses the potential market amongst mutual insurers over a ten-year period to £2 billion plus, or £200 million per year. This reflects the potential value in raising new capital for the purposes of expanding the business and developing new products, as well as a basis for raising new regulatory capital. With regards to the latter, FCA proposed in PS14/5 a basis by which mutuals with a with-profits fund might benefit from a split of their existing common fund into the constituent with-profits fund and mutual capital: where this happens, the amount of surplus to be recognised as mutual capital may in some cases be small, fuelling a need to explore new sources of capital including those that will be made possible via the Mutuals Deferred Shares Bill.

The actual size of the market will depend on the final shape of the legislation, as well as the selling rules and consequences of other regulation- including Solvency 2 and with-profits. Treasury has not at this stage sought to break down these numbers between institutional and retail investors. Our understanding though from speaking to larger members of AFM is that they would very much welcome the opportunity to market mutual shares to their existing membership base, as a means of extending membership and enhancing the relevance of the mutual model to members, as well as a basis for enabling members to take a greater stake in the business of a mutual that they admire and can see future value in.

*Q 18. Do you have any comments on our cost benefit analysis for the proposals relating to CoCos, pooled investments in CoCos and mutual society shares?*

We appreciate the detailed cost benefit analysis undertaken by the FCA, and that it is important to understand not just the transaction costs but also the potential for failures when weighing up the overall position.

We accept the compliance and training costs provided by FCA and have not attempted to research this issue separately. Clearly the costs are based on relatively low estimates of the size of the market, which would be likely to be scalable if more participants offer larger volumes of mutual shares.

With regards to benefits, as there is no market for retail holders of mutual shares, the approach taken to FCA- of measuring the benefits solely in terms of protection afforded against failure by limiting the value invested- seems quite narrow. We also see the benefits of creating a retail market for mutual shares and of the potential additional investment returns.