Jason Pope, Retail Conduct Policy
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

1 November 2016

Dear Jason,

AFM Response to FCA consultation on Mutual Deferred Shares *(CP16/21, chapter 6)*

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 briefly on the constructive proposals made by FCA, and
   - highlight questions on the cost benefit case.

2. The Association of Financial Mutuals (AFM) represents insurance and healthcare providers that are owned by their customers, or which are established to serve a defined community (on a not for profit basis). Between them, mutual insurers manage the savings, pensions, protection and healthcare needs of over 30 million people in the UK and Ireland, collect annual premium income of £16.4 billion, and employ nearly 30,000 staff[1].

3. The nature of their ownership and the consequently lower prices, higher returns or better service that typically results, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. In particular, FCA and PRA are required to analyse whether new rules impose any significantly different consequences for mutual businesses[2].

[1] ICMIF, http://www.icmif.org/global-mutual-market-share-2013
[2] Financial Services Act 2012, section 138 K: http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted

4. In addition, the Bank of England and Financial Services Act 2016 now provides an additional Diversity clause for FiSMA, to require the PRA and FCA to take account of corporate diversity and the mutual business model in all aspects of their work[3].

5. AFM responded positively to FCA's original consultation on retail mutual shares in 2015 (CP14/23), in relation then to Core Capital Deferred Shares. At the time we envisaged that the legislation on Mutual Deferred Shares would enable retail investors in mutual shares issued by a mutual insurer to be established in the same way that they were from a building society. We are grateful that FCA has adopted this position.

6. We agree with FCA's view that smaller mutuals may not be able to realise capital via Mutual Deferred Shares through institutional offerings (paragraph 6.3). This is less a reflection of the creditworthiness of the businesses, and more to do with the costs of issuing, the minimum scale of issuing appropriate to that market, and the potential impact on the purposes and priorities of small mutuals.

7. By contrast, opening up the market to retail investors might in time allow smaller mutuals to develop imaginative ways of growing their capital base, and as a result their business. Existing policyholders, who have enjoyed the experience of being a member of a mutual may value the opportunity to invest more in that business. For mutuals that serve a particular community or profession, they might be joined by other people in that community, particularly if the proceeds enable the mutual to better serve that target audience. As mutuals tend to support markets that are not well served by large institutions, this is likely to support FCA's wider consumer priorities as well. Our primary caution however, as we set out in our response to the consultation from Treasury, is that smaller mutuals are not likely to enter the market until it has been effectively established via larger mutual insurers.

8. We would stress that some of the opening comments in the chapter drew, by necessity, on the technical details of the legislation as envisaged by Treasury's own consultation. We raised a number of issues with Treasury and are seeking early clarity on these, and I attach a copy of our response. This highlights that that the certainty by which of some of the opening remarks in the chapter were written is open to doubt, though with respect to this particular consultation we do not consider this had a direct impact.

[3] http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted

9. We provide responses to questions on the following pages, as well as a copy of our earlier response to HM Treasury. We look forward to discussing further the issues raised by our response.

Yours sincerely,

Chief Executive
Association of Financial Mutuals

Responses to questions raised

1. *Do you have any comments on the proposal to apply existing rules in relation to credit institution mutual society deferred shares (in COBS 22.2) so they apply in relation to deferred shares issued by mutual insurers and friendly societies?*

We agree that this is an appropriate approach, subject to the points raised in our analysis below, and in our response to Treasury.

In particular we consider that, given time and the successful resolution of issues raised in our letter to Treasury, the proposals from FCA provide an appropriate basis for smaller mutuals to explore Mutual Deferred Shares.

2. *Do you have any comments on the cost benefit analysis for our proposals regarding mutuals' deferred shares?*

The cost benefit analysis appears to larger focus on the possibility of Mutual Deferred Shares being issued by large mutuals: paragraph 6.26 states "We assume that issuers will be classed as large firms…", whilst paragraph 6.19 suggests an estimated issuance size of between £70m and £100m. This contrasts with the approach taken in relation to building societies in CP14/23, where the range of issuance stated was between £10m for smaller building societies up to £100m for larger ones (in our view a small building society is typically many times the size of a small mutual insurer).

This rather contradicts the inference of earlier paragraph 6.3 that "Smaller societies may not be able to raise institutional funds so retail participation is important." This contradiction suggests there is still uncertainty within FCA on whether the issuing of Mutual Deferred Shares can be scaled proportionately to smaller mutuals, and we would appreciate clarity on this.

The cost case does not set out the expected cost of a single issue, but focuses instead on the costs to the sector as a whole. For a small mutual interested in an issue of say, £10 million, to retail investors only, we have therefore assumed the <u>minimum costs</u> set out in each aspect of the FCA analysis. This provides likely costs *in the first year of*[4]:

[4] Assumes average holding of £25,000 as stated in CP14/23 footnote 45

Training:	£15,000
Client classification: system:	£12,500
Client classification: investor:	£ 9,600
Appropriateness test: system:	£45,000
Appropriateness test: investor:	£16,000
Compliance confirmation:	£ 1,000
Record-keeping:	£ 800
Indirect costs:	£ 0
TOTAL	**£85,500**

This is a similar cost set out as that set out by Treasury. This equates to around 1% of the money raised, and if confirmed by practice this would, in our view, be a reasonable and proportionate cost to take into account in where a mutual is considering the benefits of raising capital for strategic reasons.

We consider though that there will be some additional costs not considered in the FCA paper, which we believe will double the overall costs; these include:

- The initial cost of seeking member permission to change the mutual's rules or constitution;
- The employment of a registrar service to retain client records specific to their shareholding, such as their certification as a 'sophisticated investor' or the acceptance of risk factors.

As regards benefits, we are strongly of the view that an effective market for Mutual Deferred Shares will enable more mutual societies to prosper, and to explore the value of raising capital directly rather than seeking a merger, or by losing their mutual status. There is ample evidence that markets with a strong mutual presence tend to be more competitive and to produce better customer outcomes. We consider that with the expectation that the current low interest rate environment continues into the long-term, mutual shareholders will find Mutual Deferred Shares an attractive place to invest part of their portfolio.

The benefits to a mutual will relate to the uses of the new capital created, but might include:

- To accelerate growth aspirations organically or through acquisitions or new business development;
- To extend the membership base of the organisation;
- To meet the needs of members to invest further in the organisation;
- To support regulatory compliance;
- To retain the capital position in an increasingly uncertain future operating environment.

Mutual Deferred Shares Consultation
Insurance, Pensions and Regulators team
HM Treasury
1 Horse Guards Road,
London SW1A 2HQ

30 September 2016

AFM Response to Mutual Deferred Shares consultation on technical policy details

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 technical details on behalf of AFM's members, and
- Contribute to a wider sector response to the consultation.

2. The Association of Financial Mutuals (AFM) represents insurance and healthcare providers that are owned by their customers, or which are established to serve a defined community (on a not for profit basis). Between them, mutual insurers manage the savings, pensions, protection and healthcare needs of over 30 million people in the UK and Ireland, collect annual premium income of £16.4 billion, and employ nearly 30,000 staff[5].

3. The nature of their ownership and the consequently lower prices, higher returns or better service that typically results, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. In particular, FCA and PRA are required to analyse whether new rules impose any significantly different consequences for mutual businesses[6].

4. In addition, the Bank of England and Financial Services Act 2016 now provides an additional Diversity clause for FiSMA, to require the PRA and FCA to take account of corporate diversity and the mutual business model in all aspects of their work[7].

[5] ICMIF, http://www.icmif.org/global-mutual-market-share-2013
[6] Financial Services Act 2012, section 138 K: http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted
[7] http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted

5. We remain very grateful for the extensive work that Treasury and government Ministers have devoted to this work. It is the first dedicated legislation in support of our sector for 20 years, and we appreciate the positive endorsement this offers of the continued relevance of the mutual business model to financial services.

6. In our assessment, the development of Mutual Deferred Shares offers a vital new opportunity for the mutual insurance market. A functioning market will enable mutuals to grow and continue to offer effective competition to the benefit of consumers and the market in general. It also offers a far more palatable alternative to demutualisation for large mutuals looking to expand.

7. From 1 January 2016 AFM underwent a change of its membership structure, with the result that we are focused primarily now on the interests of smaller mutual and not-for-profit insurers. Our members have indicated that they do not anticipate that small mutuals will be at the forefront of developing a market for Mutual Deferred Shares.

8. Once some larger mutuals have proved market demand for Mutual Deferred Shares, this view may change, and we consider the concept of a retail offering is very consistent with the way some small mutuals may wish to see their businesses expand. Indeed, retail mutual shareholders broadly share the same characteristics as existing mutual members for many mutuals, so there is potential in the future that a retail offering of Mutual Deferred Shares becomes a vital opportunity for mutuals to grow their membership base.

9. We are though continuing to work with larger mutuals in responding to this consultation, and in particular we have sponsored the sector's work on Mutual Deferred Shares, alongside LV=, One Family, Royal London and Wesleyan. We have therefore contributed to the response provided by the sponsors, and support all the points raised therein. We attach a copy below.

10. We also offer the following observations from the perspective of smaller mutuals; in order for the market to expand so that small mutuals might take advantage of Mutual Deferred Shares, we would expect to see the following established:

    a. A clear assessment of the tax consequences of issuing Mutual Deferred Shares- including that they present no risk of an issuer losing mutual status, and that any shareholder liability to tax does not impact demand for mutual deferred shares;

b. Clarity that it will not be a prerequisite for a with-profits mutual to undertake the segregation of its with-profits fund before issuing Mutual Deferred Shares;
c. Evidence that the regulatory process for firms to complete, before issuing Mutual Deferred Shares, is proportionate and appropriate to the scale and needs of small issuers;
d. Demonstration that there is demand for Mutual Deferred Shares from both institutional and retail investors;
e. Where two-thirds of customer-members of AFM member companies are members of an organisation that retains a delegate-based voting system, confirmation that these organisations can be accommodated with the legislation without the need for one-member-one-vote governance structures; and
f. Verification that the costs of issuing Mutual Deferred Shares are scalable for small organisations, and proportionate to the benefits derived.

11. We provide specific responses to selected questions on the following pages, as a member of the industry working group. We look forward to discussing further the issues raised by our response.

Yours sincerely,

Chief Executive
Association of Financial Mutuals

INDUSTRY WORKING GROUP RESPONSE

Consultation on Mutuals' Deferred Shares Regulations
Insurance, Pensions and Regulators team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Sirs

HM Treasury Consultation, Mutual Deferred Shares: consultation on technical policy details

We are writing on behalf of the industry working group on the Mutuals' Deferred Shares Regulations; the sponsors of this group are:

Family Assurance Friendly Society Limited

Liverpool Victoria Friendly Society Limited

The Royal London Mutual Insurance Society, Limited

Wesleyan Assurance Society

and

The Association of Financial Mutuals (representing 38 smaller and medium-sized friendly societies and other mutual insurers).

Barclays has also been an active participant in the working group.

This joint response is in addition to individual responses by some of the members of the group.

We greatly welcome the publication of the consultation paper and draft regulations and look forward to the opportunities that Mutual Deferred Shares ("MDS") will create to raise capital to support the expansion of mutual insurers' businesses and thus enhance the valuable contribution made by mutuals to the diversity and resilience of the UK's insurance industry.

We believe that the draft regulations offer a solid starting point for the implementation of the Mutuals' Deferred Shares Act 2015 ("the Act"), although we do also believe that they require significant further work before mutuals will be able to issue shares under them. We applaud the Government's aim of making the regulations by the end of 2016, but believe more time may be needed to resolve the matters identified in our response satisfactorily, particularly in relation to taxation, and thus to make it possible for mutuals actually to issue deferred shares.

We are grateful to HM Treasury and the other governmental and regulatory agencies which engaged with us in early discussions on the regulations last year and look forward to renewing a constructive and co-operative dialogue to develop the draft regulations so as to enable mutuals to issue shares while meeting the Government's public policy objectives set out in the consultation paper.

There are two critical issues which mutuals need clarity on, where the consultation puts forward proposals that will drastically reduce the attractiveness of MDS, or kill off the market altogether; these revolve around:

- the tax treatment of MDS, where the consultation paper suggests the issuing of MDS might cause the issuer to lose its mutual status;

- the need for a mutual to formally undertake a segregation of funds before it issues MDS.

An effective solution to these issues is a prerequisite to an effective market for MDS.

Our responses to the specific questions are:

1. **Do you agree with the definitions and limitations on the two types of mutual deferred share?**

   We acknowledge the PRA's desire expressed during our meetings last year that MDS should either have the features of restricted or unrestricted Tier 1 own funds, thus enabling the PRA readily to approve a particular issue of MDS under article 79(1) of the Solvency II Regulation[8]. However, we should point out that this is not a requirement of the Act and potentially limits the purposes for which MDS can be used as not all issuers will need MDS to meet Solvency II capital requirements. For example, an otherwise well capitalised mutual may wish to finance the purchase of a subsidiary through MDS and mutuals outside the scope of Solvency II, including discretionary mutuals, may wish to finance an expansion in their business by issuing MDS. Interest in MDS has also been expressed by potential investors in using MDS to finance 'takaful', Sharia-compliant Islamic insurance, through a UK mutual. To impose the Solvency II

[8] Commission Delegated Regulation (EU) 2015/35 of 10 October 2014

restrictions on shares which are not issued to raise tier 1 own funds will make them less attractive to potential investors and more expensive for the mutual to issue.

Of course we fully accept that where an issuer wishes MDS to act as tier 1 own funds for the purposes of Solvency II, then it needs to have all the features of ordinary or preference shares as set out in the draft regulations, but this should be a matter for the PRA to decide on a case by case basis and not set in stone in the regulations. We would point out that the features of restricted and unrestricted tier 1 own funds may change in due course, whether as a result of the review which the European Commission has undertaken to conduct into sub-tiers before 2018[9] or as a result of Brexit. Furthermore, to prescribe this in the regulations seems to run counter to the expressed aim in paragraph 2.1 of the consultation paper of providing "a minimum level of consistency and clarity about the characteristics of MDS".

We are also concerned at the limitation imposed on an issuer by only being able to issue one type of share. Once MDS are issued, they will be permanent and therefore an issuer that has decided to issue either restricted or unrestricted MDS will be bound by that choice for all time even if its circumstances change and it becomes more useful to it to be able to issue the other type of MDS in the, perhaps distant, future. We appreciate the Government's concern about the risk of misleading less sophisticated potential investors but note that it is commonplace for quoted companies to issue multiple classes of shares and other securities, which may also be bought by less sophisticated investors and do not have the safeguards proposed by the FCA for MDS in its recent quarterly consultation[10].

If the Government feels that despite the FCA's proposals, there is still an enhanced risk of confusion between ordinary and preference shares in the minds of potential investors, then this is a matter which issuers should be required to make clear, which should be a condition of regulatory approval under regulation 4(5) rather than being prescribed by the regulations. This approach again seems more in keeping with the minimum level of consistency and clarity proposed in paragraph 2.1 of the consultation paper.

We note the Government's openness to reviewing this restriction as the market develops, which suggests an acceptance that the restriction may prove not to be necessary. However, this will give no comfort to a mutual contemplating an

[9] Please see the letter dated 19 February 2016 from Lord Hill, then the European Commissioner for Financial Services to Mr Roberto Gualtieri, Chair of the Committee on Economic and Monetary Affairs of the European Parliament: https://polcms.secure.europarl.europa.eu/cmsdata/upload/eaef5ed5-cbf6-42e9-9fe5-798f3bb67b98/Answer%20to%20letter%20ECON%20Chair%20on%20Solvency%20II%20delegated%20Regulation.pdf

[10] FCA CP16/21

issue before the restriction is lifted, which would face a potentially once-and-for-ever binding choice between ordinary and preference shares, and could result in mutuals delaying, or even abandoning, a planned issue of shares.

2. Do you agree with the conditions for issuance of mutual deferred shares?

We agree with the proposed conditions in regulation 4(2)(d)-(e) and regulation 4(3)-(5).

Regulation 4(2)(a)-(c) deals with the segregation of members' and policyholders' funds, the "Project Chrysalis" issue, on which we have a number of observations:

- Project Chrysalis is relevant only to with-profits mutuals and the mechanism for the segregation of funds in chapter 20 of the FCA's Conduct of Business Sourcebook[11] applies only to such firms. Not all issuers of MDS will necessarily be with-profits mutuals and we do not believe it appropriate to impose a condition of defining funds on issuers to which it is not relevant.

- Even for with-profits mutuals, a segregation of funds as contemplated in COBS 20 is not the only approach to the Chrysalis issue, as the FCA have acknowledged[12]; different firms have approached it in different ways and none has in fact segregated its funds in accordance with COBS 20. To require all firms to define their funds imposes a single solution on firms, some of which may have resolved the Chrysalis issue without having defined their funds as contemplated by the draft regulations.

- We note a subtle variation between the language of regulation 4(2)(a) which uses the word "define", regulation 4(2)(b) which uses "distinguish" and regulation 4(2)(c) which merely requires issuers to "provide" that none of their assets constituting policyholders' interests should constitute shareholders' funds. The obligation to "provide" suggests that it could be satisfied simply by including a provision, perhaps in the prospectus for the MDS issue, that such assets should not be available to MDS holders. Is this variation in the terminology intentional? If so, we believe it would be helpful to make it more explicit in order to avoid uncertainty. If not, the expectation that a formal process will be necessary to segregate the with-profits fund will be prohibitively expensive, and with an uncertain risk on the resultant capital to the firm, and we think this will provide a significant and unnecessary hurdle.

[11] COBS 20.2.61

[12] FCA PS 14/5, paragraph 2.24

The imposition of greater restrictions in the regulations than are necessary for the protection of with-profits policyholders' interests, (which in any event will not always be relevant) will adversely affect not only the willingness of mutuals to issue MDS but also the marketability of any that are issued as investors are likely to compare MDS with the Core Capital Deferred Shares issued by Nationwide Building Society, which are not subject to any similar restrictions. We therefore believe that any segregation of funds that may be appropriate is best dealt with on an individual basis as a condition of the relevant authority's consent to the issue under regulation 4(5) rather than being the subject of blanket treatment under regulation 4(2). Again we believe this approach would be in better keeping with the minimum level of consistency and clarity proposed in paragraph 2.1 of the consultation paper.

3. Do you agree with the approach to defining distributable items?

We note that the definition of "distributable items" refers to a distribution out of profits available for the purpose as defined in s830 of the Companies Act 2006 (as modified by s843 in the case of an insurance company carrying on long term business). This raises the following issues:

- Although the definition imports the concept of profits available for distribution into the draft regulations, it does not import the various other provisions of Part 23 of the Companies Act (consisting of a further 24 sections, most running to multiple sub-sections) which further refine the concept in the context of that Act. It may be possible to infer these provisions into the regulations for an issuer that is a Companies Act company but even in that case the regulations create some uncertainty which may discourage potential investors.

- The uncertainty is particularly acute in the case of a friendly society issuer; a friendly society is not a company for the purposes of the Companies Act 2006[13] and it is unclear how s830, or the other provisions of part 23 if they are implied into the draft regulations, relate to a friendly society. The concept of distributable profits is novel for friendly societies and we believe that in order to avoid uncertainty this should be dealt with explicitly, perhaps by way of a new schedule to the Friendly Societies Act 1992 under regulation 11 and the schedule to the draft regulations.

- A further difficulty in relation to friendly societies is that the reference to s843 in part (b) of the definition of distributable items sets out limitations in what can be counted as distributable profits for insurance companies

[13] as defined in s1(1) of that Act

carrying on long term business but seems to ignore friendly societies carrying on such business.

- If the remaining provisions of part 23 are implied into the draft regulations an anomaly arises in that part 23 refers frequently to a company's 'shares' but s1(5) of the Act provides that MDS are not shares for the purposes of the Companies Act.

4. Do you agree with the proposed features of ordinary mutual deferred shares?

Please see our response to question 1. We have no comments on the proposed features of ordinary MDS which are intended to qualify as unrestricted tier 1 own funds but reiterate our view that not all issuers will wish to raise tier 1 regulatory capital.

5. Do you agree with the proposed features of preference mutual deferred shares?

Please see our response to question 1. We have no comments on the proposed features of preference MDS which are intended to qualify as restricted tier 1 own funds but reiterate our view that not all issuers will wish to raise tier 1 regulatory capital.

6. Do you agree with the criteria and process for the regulators' consent?

We have no comments on regulations 6-8 of the draft regulations save to the extent that they cross-refer to aspects of regulations 4 and 5 on which we have commented above.

7. Do you agree with the voting restrictions on mutual deferred shareholders?

We question the need for regulation 5(a)(iii) of the draft regulations which imposes a condition of "the shareholder member being prevented from exercising their voting right as a shareholder member in relation to any vote or resolution in connection with a transfer of the issuer for the purposes of demutualising the issuer". "In connection with" is a very loose phrase which creates potential uncertainty about whether a particular resolution is in connection with a transfer for the purposes of demutualising the issuer – for example, it is not clear whether a resolution to elect a director with known pro-demutualisation views would be caught or a resolution to change a firm's capital structure that may facilitate demutualisation, but may also have other purposes.

The requirements of s2(2) of the Act in this area are that the regulations should prohibit shareholder members from voting on any resolution under ss85, 86 or 91 of Friendly Societies Act 1992 and the equivalent for companies limited by guarantee. Since this is covered by regulation 9 and there is no requirement in the Act to include regulation 5(a)(iii), regulation 9 should make regulation 5(a)(iii) superfluous.

In relation to regulation 9 itself:

- It states that the listed provisions of the Friendly Societies Act, the Companies Act and the Insolvency Act "do not apply" to shareholder members. This does not match with the actual wording of these Acts. For example, s86 of the Friendly Societies Act states that a friendly society transfer of engagements requires a special resolution of the society's members and part 26 of the Companies Act provides that the court can sanction a company scheme of arrangement if approved by a 75% majority of each class of member. Therefore, what we believe regulation 9 needs to say in relation to ss85, 86 and 91 of the Friendly Societies Act is not that they "do not apply" to shareholder members, but that the special resolution may be passed as a special resolution of ordinary members, not of all members and, in relation to company schemes of arrangement, that the court can sanction a scheme notwithstanding that it has not been approved by a 75% majority of shareholder members voting on it.

- Regulation 9(b) prohibits shareholder members from voting on <u>any</u> scheme of arrangement by an insurer that is a company limited by guarantee. This goes much further than is required under the Act, which requires the regulations only to prohibit voting on resolutions that have a similar effect to ss85, 86 and 91 of the Friendly Societies Act, including a resolution for a scheme of arrangement <u>having that effect</u>. In fact, a company limited by guarantee might wish to enter into a scheme of arrangement for many purposes unconnected with a demutualisation, such as a capital restructuring. This could affect the shareholder members (and indeed is quite likely to) and natural justice requires that they should be able to vote on it. Regulation 9(b) therefore needs to be limited to resolutions having a similar effect to resolutions under ss85, 86 and 91 and, in the case of a scheme of arrangement, also to make provision for the scheme still to be valid even though a class of members of the company have not approved it by a 75% majority as required under s899 of the Companies Act.

In addition, the references to one-member-one-vote in paragraph 2.16 of the consultation paper does not take account of the delegate voting system retained by a number of friendly societies. The drafting of regulation 5(1) appears to follow that of s2(1) of the Act in stating that shareholder members should not have more than one vote but greater clarity would be helpful in expressly permitting voting systems other than one-member-one-vote. Otherwise the implication is that unless shareholder members are able to vote on a one-member-one-vote basis, the society would be unable to issue MDS. Therefore a society with a delegate based voting system would need to ask its members to accept significant constitutional change in order to issue MDS.

8. Do you have any comments on other provisions of the draft regulations?

We note that various terms are used in the draft regulations with special meanings, eg "issuer" and 'appropriate authority", but are not defined in regulation 2.

The references to the "constitution, memorandum or rules" of the issuer might usefully also include articles of association. The constitutional documents of an incorporated friendly society are its memorandum and rules and those of a company limited by guarantee are its articles of association.

No amendments are proposed to the Friendly Societies Act 1992 under regulation 11 and the schedule to the draft regulations. As noted in our response to question 3, we believe that the Friendly Societies Act requires extensive amendment to introduce the concept of distributable items for friendly societies. Other amendments to the Friendly Societies Act would include:

- an amendment to section 5 to make clear that shareholder members are members notwithstanding that they do not receive insurance or other benefits from the society; and
- an amendment to paragraph 4(1) of schedule 3 to add the issue of MDS to the list of the matters that a friendly society's memorandum should contain (which is necessary to enable societies to comply with regulation 4(4) of the draft regulations).

9. What up-front and ongoing costs would an individual mutual face to issue mutual deferred shares, and which of these arise directly from the draft regulations?

A mutual considering issuing mutual deferred shares will be faced with a significant range of costs:

- They will need to seek the permission of members to a change in their rules: the costs of this will depend on the size of the organisation and whether they can incorporate this into their Annual General Meeting.

- There will need to be extensive engagement with regulators to support their approval processes, with attendant legal expenses.

- If the mutual is a with-profits mutual and they are required to complete a segregation of funds prior to issuing, the exercise will be expensive and time-consuming in its own right.

- The cost of issuing MDS will vary significantly, according to the size of the issue and whether it is issued to institutional or retail shareholders, or a combination of both.

To illustrate some of these costs:

- A member mailing exercise and AGM may typically average around £1 per member.

- Where a smaller mutual recently undertook a segregation exercise, the total cost was over £1 million.

- Where some mutuals have recently issued debt to institutional markets, the costs - which are largely fixed - have been in the order of £4 million.

These are all extensive costs, and substantively different to the figures set out in the consultation paper. The question refers to costs which arise directly from the draft regulations, but as these add additional technical clarification to the original Act, it is not straightforward or relevant to separate out these particular costs.

Costs for legal advice in engaging with regulators, or for issuing MDS to retail clients will vary significantly according to the business and the size of the issue. We consider though that they inevitably be many times greater in all cases than the figures suggested in the consultation paper.

10. What quantifiable financial benefits would a mutual obtain from issuing mutual deferred shares, over what period, and which of these would not be possible without the regulations?

We believe this question is better answered individually by prospective issuers.

11. How many mutuals plan to issue mutual deferred shares, in what volume and how frequently?

We believe this question is also better answered by individual mutuals rather than in a joint response. It will also be necessary to provide clarity on a number of key issues highlighted in this response before it is possible to consider what form the market for MDS will take.

12. Do you have any views on the potential tax implications of the issuance of mutual deferred shares?

We believe that the proper analysis is that the purpose of the MDS is to raise capital to support the mutual's insurance business and that that business remains to provide insurance for the benefit of its policyholder members. Therefore, the generation of profits to service the MDS should be regarded as subordinate to the mutual insurance business and the profits distributed to MDS holders would be an expense of that business, not a business objective in their own right. If that analysis is accepted, then the mutual ought not to be subject to corporation tax as a result of having issued MDS.

It is unsatisfactory to leave it to the courts to decide when the business is mutual. An issuer will need certainty that a proposed issue of MDS will not trigger the loss of its exemption from corporation tax; otherwise no mutual board will risk proceeding with an issue in view of the potential impact on wider policyholders. Certainty can be provided by legislating to provide a clear cut-off point below which mutuals will know with certainty that the issue of MDS will not jeopardise their tax status. We would welcome the opportunity of discussing with officials how this cut off point could be framed. For friendly societies further clarity can be providing by modifying Part II of the Friendly Societies Act to make clear that the issue of MDS is one of the powers of an incorporated society and not one of its purposes.

There is no mention in the consultation document about the taxation treatment of MDS in the hands of investors. Investors will need certainty on the tax treatment before and issue of MDS can be contemplated. We would therefore also welcome the opportunity of discussing the taxation treatment of MDS in the hands of investors with officials.

We hope this response is helpful and as industry representatives we look forward to continuing the close working with the Treasury and regulators, as noted in paragraph 1.9 of the consultation paper, to make mutual deferred shares a reality.