How can mutuals raise capital without destroying the mutual principle?

The All-Party Parliamentary Group for Mutuals

Report of Short Inquiry
Published September 2014

Statement from the All-Party Parliamentary Group for Mutuals

The purpose of the Group is to discuss and support all mutual forms of business.

This Short Inquiry Report was authored by Peter Hunt of Mutuo, following two special hearings conducted by the All Party Group. It has been produced in the interest of furthering the general understanding of the issues raised and facilitating a contribution from Parliamentarians.

Mutuo has not been paid to produce this Report; the cost of the inquiry transcripts and printing the Report is charged to the All Party Parliamentary Group.

Mutuo acts as administrative secretary to the Group, for which it is paid a fee of approximately £9,000 per annum.

Contact:
Mutuo
Administrative Secretary to the Group

p.hunt@mutuo.co.uk

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1. The All-Party Parliamentary Group for Mutuals Panel

The All-Party Parliamentary Group for Mutuals has Members from both Houses of Parliament. The Purpose of the Group is to discuss and support mutuals.

Listed below are all the Members who participated in the hearings.

Hearing 1 February 2014

Jonathan Evans MP – Chair	Cardiff North
Adrian Bailey MP	West Bromwich West
Steve Baker MP	Wycombe
Jim Dobbin MP (deceased)	Heywood and Middleton
Ian Lucas MP	Wrexham
Andrew Love MP	Edmonton
Lord Gordon of Strathblane	
Rt Hon Lord Hunt of Wirral	
Baroness Maddock	
Rt Hon Lord Naseby	

Hearing 2 April 2014

Jonathan Evans MP – Chair	Cardiff North
Steve Baker MP	Wycombe
Michael Connarty MP	Linlithgow and East Falkirk
Mark Durkan MP	Foyle
Cathy Jamieson MP	Kilmarnock and Loudon
Chris Leslie MP	Nottingham East
Andrew Love MP	Edmonton
Gareth Thomas MP	Harrow West

2. Terms of Reference

This special inquiry examined issues related to capital raising in mutuals. Members of the All Party Group wished to better understand the issues facing mutuals which are seeking to raise capital. In particular, the Group is interested in understanding how legislative and regulatory constraints work to limit the ability of mutuals to compete with plc counterparts.

The sessions gave Members of the Group, who have an active interest in financial mutuals, the opportunity to hear from key figures from the mutual sector about the practical issues they face in these matters, and to put their concerns to representatives of the regulatory authorities.

3. Introduction

There is no doubt that the UK financial services system has become more concentrated through the experience of the global financial crisis. The consequence of that is there is less choice for consumers and less competition in the high street. The market is dominated by plc firms whose primary interest is serving their shareholders.

In banking, the problem is acute - it has been caused by a combination of the withdrawal from the UK of certain foreign banks, but more notably by the slow motion disaster of demutualisation. Not a single demutualised building society succeeded as a bank. All were either absorbed into larger conglomerates or simply failed, and were rescued by the taxpayer. In the insurance industry we see a market similarly dominated by listed firms, with a small recovery of market share by the remaining mutuals since the crisis.

In the words of Andrew Bailey, the Deputy Governor of the Bank of England, simply put, ‘The demutualised building society model failed.’

This is more than of academic interest to this All-Party Parliamentary Group. We can draw direct lessons from this experience, but one clear message is that the mutual sector needs to be appropriately regulated, and benefit from a fit for purpose legislative regime, in order to play its part in a diverse financial services business.

As Government and Regulators have acted to shore up the industry, the additional capital requirements put particular strain on mutuals, which themselves, were not the cause of the financial crisis.

In accepting the general rule that capital must be maintained at prudent levels, it is imperative that mutuals are not disadvantaged by their very structures that make rapid accumulations of capital very difficult.

To safeguard mutual businesses, to serve consumers and the manage risk in the economy, the challenge therefore is to amend the capital regime in mutuals to permit the injection of external capital, whilst safeguarding both the core purpose and mutual integrity of the business.

We can point to existing examples where this has been achieved in other countries such as Canada, France and The Netherlands. Similar provisions should also exist in the UK but in this session we want to explore the limitations of the current regulatory regime and assess what issues are holding back mutuals from accessing additional high quality capital.

This special inquiry examined a number of issues related to capital raising in mutuals. Members of the All Party Group would not only like to better understand the issues facing mutuals which are seeking to raise capital, the Group is interested in understanding how legislative and regulatory constraints work to limit the ability of mutuals to compete with plc counterparts.

Evidence was taken in select committee style in the Hearings. Invitations were extended to witnesses from the financial mutual sector and the Regulatory Authorities. All oral evidence was recorded verbatim. A list of witnesses is recorded in this report. This report was produced solely in the interest of contributing positively to the debate.

I would like to thank all those organisations and individuals who gave evidence to our Hearing and to members of the Group. The Inquiry makes a number of recommendations and we will pursue these with the Government, The Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).

The Group welcomes the high level and serious engagement that it received from the PRA. The same level of engagement was not apparent from the FCA during our conversations with them and we were obliged to contact them in writing. Whilst we are satisfied with the consideration given to these questions, the Group would expect a more co-operative approach from the FCA in providing equivalent senior witnesses to our sessions.

We present in this report a number of recommendations that we now submit to HM Treasury, the Prudential Regulation Authority, the Financial Conduct Authority and not least, the financial mutuals themselves. Action is now required and we will remain vigilant in driving this agenda forward.

Jonathan Evans MP, Chairman

4. Summary Recommendations

1 New Capital Instruments for mutuals are required so that members can contribute to their future growth

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1.2 All mutuals need to develop innovative new ways of raising capital that do not conflict with their core business purpose

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4. There is greater collaboration amongst member owned businesses in Europe. The UK (regulators/businesses) should examine the reason for these trends and examine potential barriers stopping greater collaboration here

4.1 UK mutuals do not collaborate together sufficiently, and they should make more effort to work together to share services and build strategic alliances in order to strengthen the sector

5. Inquiry Report

5.1 New Capital Instruments for mutuals are required so that members can contribute to their future growth

By their very nature, mutuals are limited in how they can raise capital. Like all businesses, they can retain profits and can borrow against future earnings, but they have no equity shareholders and so do not have access to this type of prime capital.

However, mutuals were not designed with capital investors in mind. They exist to serve their members who will be customers, employees or defined communities. Where members have contributed capital to their mutual enterprise, it is not to speculate for capital gain but to fuel the business.

Large mutuals are thus created patiently, and over a long time – requiring sustained periods of business success to grow. The lack of external capital is sometimes cited as a strength in the process of building patient, risk averse mutual businesses, which can concentrate on the job in hand, rather than the short term needs of capital investors. However, it can also limit their flexibility in adapting to new market conditions, and their ability both to secure maximum investment in the business and to grow through acquisition.

These restrictions are well known and mean that the debate around capital in mutuals is not new. To date however, in the UK at least, mutuals have not made significant alterations to their basic capital framework, which was designed more than 150 years ago. The reason for this is that mutuals have been wary of introducing external capital into their business for fear that it could subvert the purpose of the firm and could lead ultimately to demutualisation in extreme cases.

> ‘What we see as the limitation that that causes is that our members cannot grow as quickly as they would like to. They may not be able to develop the range of products that they want to or that they feel a mutual should be able to offer and they cannot look for the kind of acquisitions that will help to strengthen their business more generally. In short, a limitation of access to capital is not just bad for our businesses but also it is bad for our customers.’
>
> Martin Shaw, Association of Financial Mutuals, Session1

5.1.1 Building societies have led the way in developing new capital instruments

The Group heard that building societies typically rely upon retained earnings for their capital base and supplement that with hybrid forms of capital: Permanent Interest Bearing Shares (PIBS) in the past and for Nationwide, Core Capital Deferred Shares (CCDS) since last December.

Until very recently PIBS was the normal form of capital that would supplement retained earnings. But since EU Capital Requirements Directive IV and the Capital Requirements Regulation, the definition of capital no longer would allow permanent interest-bearing shares to count as common equity Tier 1, and along with the grandfathering rules, there will come a point in 2019 where it does not contribute anything to the capital base at all.

> 'The reason why permanent interest-bearing shares failed was because they are not regarded as a permanent form of capital: they are typically operated with call dates and, secondly, they are not deemed to be loss-bearing on a going concern basis.'
>
> Graham Beale, Nationwide Building Society, Session 1

The Group was interested in the options mutuals have available to them in raising more capital and what legal constraints there are on those choices.

> 'Core Capital Deferred Shares (CCDS) were developed in order to get UK and European regulators and authorities to try to agree a definition of capital which will allow building societies to have a continuation of supplementary capital on the balance sheet but one which would not compromise the mutual model and will look as close to common equity as you could get.'
>
> Graham Beale, Nationwide Building Society, Session 1

5.1.2 All mutuals need to develop innovative new ways of raising capital that do not conflict with their core business purpose

The mutual sector of building societies, co-operatives, friendly societies and mutuals insurers should learn from the experience of Nationwide and take the initiative to develop new types of mutual shares that can be offered to existing and future members. Such shares will serve the dual purpose of raising additional capital and further engaging members in the economic and social purpose of each mutual.

In seeking to innovate in this way, mutuals are likely to encounter a number of barriers that will need to be overcome – inflexible legislation, a lack of policy drivers, inappropriate regulation and a general lack of understanding about mutual business structures. Each of these will need to be overcome and this report suggests ways that this may be achieved.

The regulatory authorities must recognise the wider importance of capital in mutuals - not just as an injection of funds into the business, but as an injection of vibrancy as a way for existing members to demonstrate their broader interest in the organisation and as a way of bringing new people into mutuals.

5.1.3 Regulators should engage directly with those designing such instruments, so that they understand the nature of what is being developed, and how they can be integrated into the investment options of corporate and retail options

Initiatives from the mutual sector should be welcomed and lead to a collaboration with Regulators to ensure that any new capital instruments are suitable for use in UK markets. Such a co-design process would ensure both that instruments are fit for purpose, but also have the added advantage of deepening the regulators' understanding of the mutual business sector.

The contrasting experience in the building society sector, where Nationwide successfully developed Core Capital Deferred Shares, in tandem with and to the satisfaction of the Regulators, whilst Ecology has struggled to make headway in issuing its own instruments shows an inconsistent approach.

Outside of the building society sector, Regulators cannot be described as pro-active in resolving mutual capital issues. In most cases, the experience of mutuals has been that there has been little positive engagement, though there are signs of improvement in recent months – we can speculate if this is a direct result of this inquiry.

We would expect to see an open door from Regulators, and indeed policy makers at HM Treasury who have not shown leadership in any of these discussions, particularly in relation to friendly societies and mutual insurers, where engagement has been minimal and less than helpful. The Group hopes that this is an error of omission rather than anything more.

5.1.4 Government should be prepared to assist by supporting moves that remove legislative barriers to new capital instruments for mutuals

For Nationwide, the Building Societies Act was sufficiently agile in permitting the development of a new capital instrument.

> 'The work the Nationwide has done is front-running in terms of their capital instrument that now has gone into the market.'
>
> Martin Stewart, Prudential Regulation Authority, Session 2

This is not the case for either friendly societies and mutual insurers or indeed co-operatives and community benefit societies. In those cases, this means that primary legislation is required to remedy this shortcoming. Government should support any efforts by the sector to resolve these points itself, and provide policy and political support to such moves.

Lord Naseby's Private Members Bill (Mutuals' Redeemable and Deferred Shares Bill 2014) provides an immediate opportunity to tackle the need for new capital instruments. Government should join with the growing cross party consensus in favour of this Bill and work with Lord Naseby to ensure it achieves Royal Assent.

Beyond this specific piece of legislation, there is a need to review each of the Acts that govern mutuals to ensure that they are fit for purpose, sufficiently flexible and open to new innovations that will permit mutuals to play a full part in a diverse UK economy.

The Group recognises the modest advances that have been made in Building Societies, Co-operatives and Credit Unions legislation over the past few years but argues that this falls short of the major overhaul that is required.

A Treasury led working party should be established to examine the legislative barriers to a larger and stronger mutual sector and the likely benefits that new legislation for mutuals may bring to the UK economy. It should report in six months.

5.1.5 The Financial Conduct Authority should abandon its existing definition of ‘sophisticated’ and ‘unsophisticated’ investors which is simplistic and ill-conceived

The group heard that Nationwide explored, at a fairly early stage in the evolution of CCDS, whether this would lend itself to being something that was available to the general public. It appears that the FCA in particular was very concerned that if the instrument was to be made generally available to ‘unsophisticated investors’ who did not appreciate the difference between cash savings and an equity instrument then. So the Nationwide CCDS launch was aimed entirely at institutional investors.

Similarly, Ecology Building Society has sought to offer investing shares to its members.

> ‘Ecology was the only building society that issued deferred shares to our members under the 1962 Building Societies Act. We held those deferred shares for the majority of our existence.’
>
> Paul Ellis, Ecology Building Society, Session 1

In both cases, it has been deemed inappropriate for either mutual to offer shares to retail investors as they may, in the view of the FCA, confuse individuals.

> ‘Will the ordinary retail consumer really understand what this instrument is? The first question could be do they understand that when they are putting their money in that it is not actually guaranteed in terms of the deposit protection? The second is if they understand that, do they really understand that it is different from ordinary equity, so do they understand that actually it is something which is rather complex, is illiquid and is difficult to value?

These are concerns that we have, and that is why we are going out with a consultation paper because we absolutely have very clear in our minds the importance of our competition objective, but we need to balance that out with consumer protection, and we do not see that these sort of instruments are ones which are suitable for your ordinary retail consumer.'

Katrina McTeague, Financial Conduct Authority, Session 2

There was sharp disagreement between witnesses about this issue.

'For us as a small mutual with this close identification with our membership and our members having a close identification with what we are trying to do through our lending policies, it is absolutely right that they should be entitled to exercise a democratic choice to invest in the capital of the society of which they are members. If we proceed with an issue that is entirely focused on institutions, effectively, we skew the position for the future if it becomes possible for us to subsequently allow our members to take our capital.'

Paul Ellis, Ecology Building Society, Session 1

Group members sought to probe the FCA position further. As the Chairman pointed out,

One of the features of mutuals is that customers own the business, so they have got both functions, and therefore if you just treat them as having the one function, in a way, you can produce the outcome of undermining the whole of the concept of mutuality.

Jonathan Evans MP, Session 2

Is not the point (in a mutual) to engage your customers and your employees in what you are doing?

Steve Baker MP, Session 2

Members put to the FCA the evidence that it had heard from Ecology Building Society, for example:

'Investors in our society would describe themselves as social investors and typically would hold other investments in a range of other social investments. Typically those investments might only constitute £500 to £1,000, which suggests to us that these individuals have quite a sophisticated view of risk. They are willing to commit small amounts to this type of investment but they are not necessarily going to put the whole of their personal capital at risk, and nor would we wish them to do that.'

Paul Ellis, Ecology Building Society, Session 1

Yet the FCA held firmly to its view.

> ‘We set out our approach to these instruments in what we called Policy Statement 13/3 last year, we do not believe these instruments to be appropriate for ordinary retail investors in general. We intend to consult on a marketing restriction on these instruments later this year, which we will do. We do understand the impact that this policy has on smaller mutuals in particular, and we stand willing to engage with those organisations to try to square this circle between sustaining a diverse sector on the one hand and protecting customers on other.’
>
> James Bell, Financial Conduct Authority, Session 2

The PRA was more equanimous in its evidence.

> ‘I have a lot of sympathy with your view that people who are members of mutuals should be able to own these instruments. That is what membership means. Of course, on the Continent… mutuals do issue that type of capital instrument to their members and the building society model does not have that feature to it. What I think we have got to overcome is the experiences which we have had which are quite difficult when you get people saying, “I’ve invested my savings in this because I’ve got the yield that I was looking for in terms of nominal returns” and you say, “I’m sorry, but that is a bank capital instrument”.‘
>
> Andrew Bailey, Prudential Regulation Authority, Session 2

On balance, the Group believes that the FCA position shows an over-conservative approach that does not reflect the real world. On the one hand, the FCA believes the public should be ‘protected’ from such ‘complicated’ instruments, whilst ignoring the responsible member-funding of mutuals that exists in other countries, and indeed was used to fund building societies such as Ecology in the past, or many co-operatives which are still funded by withdrawable share capital, which has no such restrictions.

Equally, the restriction smacks of overkill in a world where individuals can make financial decisions in a wide range of scenarios without statutory or regulatory ‘protection from themselves.’ The Group believes that appropriate disclosures will suffice to inform retail investors about the nature of any risk they are undertaking. After all, the liquidity of the stock market did not protect investors in failed plc banks in 2008.

Members look forward to a positive result from the expected FCA consultation on this matter. Moreover, Members will be looking to see that the assurance received from the FCA is borne out:

> Can you reassure us that you are not placing additional responsibilities on mutual businesses and that other instruments of a complex nature may be sold to retail consumers and there is a level playing field in operation here?
>
> Andy Love MP, Session 2

We hope that a more balanced approach will result from this consultation which, whilst ensuring proper labelling and explanation of financial instruments, places the regulatory emphasis on the stability and soundness of the instrument at hand rather than on the suitability of the potential investor.

One of the great things about mutuals is that it gives the opportunity for people who do not own very much to have ownership, control and risk bearing in, for what want of a better term, a capitalist enterprise, a business.

I will be really sad if we cannot find a way with all this regulatory apparatus to make it possible to reinvigorate that sense of ownership “This is my life insurance firm”, even “my hospital” in the past. “This is mine. I own it along with my brothers and sisters.”’

Steve Baker MP, Session 2

5.2 Regulators should have a legal duty to promote corporate diversity

5.2.1 The Group believes that Parliament should alter the legal terms of the (PRA and FCA) to introduce a legal duty to promote corporate diversity

> 'The definition of capital has been a major struggle for co-operatives and for mutuals because the mainstream thinking always lies on the joint stock company.'
>
> Volker Heegemann, European Association of Co-operative Banks, Session 1

We recognise that the Regulatory Authorities can only operate under a clear mandate that they have received from Parliament. It is pleasing to see that the FCA has a new responsibility to promote competition, and in time, we believe that this will benefit both smaller and new entrants to the financial services sector.

The history of the UK financial services industry shows that mutuals have been the true 'challenger' institutions to the largest corporate banks and insurance businesses. Only as a result of demutualisation did they lose market share to the monolithic shareholder owned service providers in the last 20-30 years.

The Group heard how the UK experience contrasts with that of other countries in the EU and across the western world. In many EU countries, there has been a much better level of understanding of mutual business types among regulatory bodies. This is not culturally based, but more as a result of close engagement between the sector and regulators over the last 20 years. This experience could, and should be emulated in the UK.

The UK experience that led to such a concentration of the financial services market is directly derived from specific policies, supported by legislation and facilitated by regulation over a period of decades. This must be reversed if we are again to have meaningful competition and choice for consumers.

The FCA was positive in its evidence concerning the importance of corporate diversity and pointed to its new responsibility to promote competition.

> 'When it comes to looking at competition, in our view it is very important that there is a strong competitive environment within the UK and that is not just about the number of players, it is also about the diversity of players. When we talk about diversity that is about whether you have got challenger banks, whether you have got mutuals and so on.'
>
> Katrina McTeague, Financial Conduct Authority, Session 2

The Group welcomes this and recognises that it is a step in the right direction. It also shows that the regulatory authorities respond well to new and specific responsibilities from Parliament.

In practical terms this means that in addition to the changes brought about since the Financial Services Act 2012, the Financial Services & Markets Act 2000 must be amended further. HM Treasury should take the initiative to do this by bringing forward proposals that will require our Regulatory bodies to promote all types of corporate diversity – not just mutuals - as an alternative to the plc dominance of the market.

5.2.2 It is damaging to any understanding of corporate diversity and confusing to consumers if the Co-operative Bank maintains its name when it is no longer owned by a co-operative

The term 'co-operative' is protected by law for a reason. No new business may be registered using this description if it does not satisfy the Regulator (Financial Conduct Authority) that it is a bona fide co-operative. It is confusing and misleading if the term is applied to firms that are, or are no longer, co-operatively owned. Not only is it likely to confuse and potentially mislead the public, this has negative repercussions for other member owned businesses.

Group Members noted that people deliberately choose to sign up to use the Co-op Bank's facility because they think that it is a co-operative. It has not had a directly co-operative structure but it has been owned by a co-operative.

Group Members are concerned that the term is not allowed to fall into mis-use. The power to decide if the 'co-operative' name may be retained is held by the Secretary of State for Business, Innovation & Skills, with continuing responsibility for business registrations held by the FCA.

The FCA has the power to prevent the use of the "Co-operative" name, and to take other action regarding the Bank's branding, if the FCA considers this desirable to protect consumers, to promote competition in the interests of consumers or to protect the market integrity.

Members asked the FCA how low co-operative ownership would need to drop before it believed there must be a consumer detriment or an element of being misled. While the FCA told the Group that it currently sees no need to intervene, the matter is subject to ongoing review.

In coming to our current view we have taken into account a range of factors, including the ownership structure, the steps its new owners have taken to maintain the firm's ethical character and in particular the substantial publicity around the change of ownership. Evidence of widespread consumer confusion is one of the factors that might cause us to revise this position, but it would be a decision is taken in the round taking into consideration a number of factors.

Financial Conduct Authority, Written Submission

The Group believes that it is an error to conflate a firm's 'ethical character' with its ownership structure. This point about 'ethics' is open to any number of interpretations, none of which are in accord with the globally recognised International Co-operative Alliance statement of co-operative identity. This mistake is all the more surprising given that the FCA is the body responsible for ensuring that co-operatives registered in the UK conform to these principles.

The Co-op remains the largest single share shareholder but it is not the majority shareholder any more … it has obviously got to rediscover or discover a business model. It has gone through a very difficult experience. It has come out as undoubtedly a different institution.

Andrew Bailey, Prudential Regulation Authority, Session 2

The All Party Group believes that since the Co-operative Group is no longer the majority shareholder in the Co-operative Bank, the Government should act to ensure that the term 'co-operative' is no longer used in its name. This also presents the opportunity to refresh the conditions for usage of the term by any business that alters its ownership structure away from co-operative ownership.

5.2.3 The manner in which Regulators have dealt with mutuals offering with-profits products is indicative of a poor grasp of how mutuals operate, and this approach has created uncertainty and a continued risk of shrinkage of the mutual sector

The FCA's position on Mutuals with a with-profit fund remains that 'all or almost all' of the capital in such a firm belongs to the current generation of with-profits policyholders. This view has its roots in a Treasury ruling from the early 1990s, in relation to proprietary firms with share capital separate from the policyholder funds.

The regulation which governs with-profits business was designed originally to regulate proprietary companies and particularly to deal with the temptation to which they are naturally subject to favour their shareholders over their with-profits policy holders.

This works for a proprietary company which has a separate shareholder fund that that can be used for developing other parts of its business, but a friendly society or mutual insurer has only its with-profits fund. Therefore if the same reasoning is applied to the sole source of capital of a mutual with-profits insurer, then it cannot invest with the same freedom as a proprietary company and so is at a severe competitive disadvantage. If applied to friendly societies and mutual insurers, which have no share capital, the result is that with-profits policyholders are deemed to own 'all or almost all' of the capital of the firm, regardless of other member interests. This capital that may have been accumulated over many years, and in part at least, through business unrelated to with-profits.

The Financial Services Authority (FSA) sought legal advice which supported this assertion, yet is strongly contested by mutuals themselves, with equally weighty legal Counsel giving an opposing opinion. The establishment of the FCA was an opportunity to seek a fresh opinion, yet the FCA instead sought to clarify the original view with the same Counsel.

> The FCA commissioned fresh advice from the original external Legal Counsel, but as a result, the FCA's understanding of the legal position did not change from the legal understanding of the FSA. Commissioning new (i.e. different) Counsel could lead to further uncertainty, and may not resolve the position in any event for any particular firm and its circumstances.
>
> However, importantly, we have highlighted in our recent Policy Statement (PS) that we recognise that there are other legal views and as such there is legal uncertainty. We also say in the PS that depending on the facts of the case it may be in the interests of policyholders to resolve the uncertainty by an appropriate 'compromise'.
>
> Financial Conduct Authority, Written Submission

The Group believes that this situation is unsatisfactory and that it had dragged on for far too long without a sensible resolution. Clearly, the original legal view obtained does not take account of the different ownership structures in the mutual sector. It is clear evidence of a long-standing misunderstanding of mutuals by UK Regulators.

The fact that legal opinion in this is, at best, moot, is acknowledged by the FCA, but it seems perverse that this leads it to conclude that clarification would 'lead to further uncertainty.'

> 'There has been a long discussion over what is getting on now for five or six years, first with the FSA and more recently with the FCA, about allowing mutual insurers to split their with-profits funds and recognise what is called mutual capital within them.'
>
> John Gilbert, Hogan Lovells International LLP, Session 1

HM Treasury has not taken a policy lead in this matter through successive Governments, and this is to be regretted. FCA's Policy Statement has provided a solution, designed in certain circumstances, to provide a with-profits mutual, to waive part of the FCA and PRA rules. However, this has been designed to be available primarily when the with-profits fund is in run-off. So whilst the FCA solution is designed to create a separate mutual members' fund (or mutual capital), their contention that 'all or almost all' the money in the with-profits fund belongs to today's with-profits policyholders, means that the capital available for the rest of the business may be much smaller than is necessary. The more effective solution therefore is to allow mutual insurers to raise other kinds of capital which can be used to fund that kind of business-such as that provided in Lord Naseby's Bill.

The Group does not believe that this matter has been satisfactorily dealt with. In the absence of a settled legal view on this, which would be a better solution, Members call upon the FCA to ensure that it applies suitable flexibility in resolving this matter with individual firms, and to apply a range of solutions that meet the individual needs of mutual insurers and friendly societies. The Group will keep a close interest in how this process is managed over the next few months.

5.3 There is a real need for policy makers, regulators and legislators to better understand how customer owned mutuals operate, the nature of their business offering, the challenge of raising capital and how this impacts on their relationship with members

The Coalition agreement states that it is desirable that there should be diversity in terms of ownership of financial services businesses. The Group was concerned that the Regulatory authorities should reflect this in the way they undertake their duties.

However, the evidence from the industry points to a weakness in execution of this commitment. This is particularly true of the friendly society and mutual insurance sector that have not benefitted from any policy improvements under the present Government. The Group fears that these businesses have been completely overlooked.

> 'Much of the systemic risk (but not all of it) is related to the proprietary sector, but is it the position of the regulator that it is completely even-handed in its approach in relation to proprietary business and mutual businesses?'
>
> Jonathan Evans MP, Session 2

The Group is keen to see more evidence of a connection between policy makers – those responsible for delivering the Coalition Agreement commitments, and the Authorities responsible for supervising firms on a day to day basis.

> 'I just wondered whether there is sufficient proactive assistance by the "authorities" to actually make sure that for some who are very small institutions with limited capability or space to go off and dream up new capital instruments… Can you do more to help firms think through scenarios to model what might be around the corner as business opportunities or business risks for these small institutions? '
>
> Chris Leslie MP, Session 2

The PRA argued that it took an even handed and fair view in the exercise of its duties.

> ‘We are a proportional regulator in the way in which we apply our approach to supervision - and we do that quite deliberately because we are most focused on those that can cause most damage to the financial system - we do put a lot of emphasis on understanding the different sectors that we have… We certainly do seek to understand mutuals because we seek across the board to understand business models.’
>
> Andrew Bailey, Prudential Regulation Authority, Session 2

> Parliament…has recently given us a secondary objective in respect of facilitating competition in the markets in which our firms are operating and so that is an important connection to the whole question of mutual business models.
>
> Andrew Bailey, Prudential Regulation Authority, Session 2

The PRA should be commended for the way in which it has employed specialist skills with an understanding of the building society sector. This should be replicated across all disciplines in the PRA and quickly adopted in the FCA too.

On balance, the Group believes that this process should be accelerated and proposes that HM Treasury and Regulators should produce an action plan to ensure that all relevant staff engage directly with mutual businesses, with suitable secondment opportunities considered.

5.3.1 There is an argument that mutual business has a different risk profile and that this should be reflected in the way Regulators deal with mutuals

The Group explored the potential impact of leverage ratios on mutuals and wished to examine whether they impacted disproportionately on building societies.

Evidence was given asserting that the leverage ratio must recognise the particular nature of the building society business model, and be set at a level that reflects the lower risk profile of mutual business.

> ‘We are not allowed to make markets, we are not allowed to trade in derivatives or undertake any of the activities that the investment arms of global banks would operate in, so it is a very restricted and low-risk model. However, when it comes to the capital requirements, and particularly at the Nationwide level, we really are treated on a par with the banks in terms of the capital ratios that the regulators require of us, particularly for us the leverage ratio which is the less sophisticated of the capital measures.’
>
> Graham Beale, Nationwide Building Society, Session 1

Members were concerned that increased capital ratios will drive firms to take more risk in order to create more value that is necessary to remunerate higher levels of capital. It was argued that they create a tipping point at which the leverage ratio could start to undermine the mutual model because if the business is primarily based on retail mortgages financed by retail savings, the profit margin would be insufficient to support capital ratios of for example, 5.5/6 per cent.

> ‘If we see a continuation in the rise of capital requirement for mutuals, and particularly the leverage ratio, there comes a point where if the leverage ratio is taken to too high a level that it starts to compromise our ability to operate as a lower risk institute.’
>
> Graham Beale, Nationwide Building Society, Session 1

The restriction on the business model is embedded in the Building Societies Act: they are required by law to have a minimum of 75 per cent of their assets secured on residential property in the UK. Their funding has to come as a minimum of 50 per cent from retail source.

Yet this view was robustly challenged by the PRA, talking of leverage ratios:

> It is not a risk-based measure…You have a risk-based capital ratio, you have a leverage ratio and you have stress tests. You can use those three things and they are often at the heart of capital supervision. The leverage ratio does not replace it.
>
> Andrew Bailey, Prudential Regulation Authority, Session 2

> There are certain characteristics around mortgage banks and the Nationwide that have used the advanced models where there is a specific impact on the leverage ratio, but it is our view that it does not impact the whole of the building society sector… If you take the Nationwide out and look at the remaining building societies, they have an average leverage ratio of over six per cent which is obviously considerably higher than when the PRA put out the announcement last year of three per cent.
>
> Andrew Bailey, Prudential Regulation Authority, Session 2

In response to this contribution, Members sought assurances that the different profiles of building societies would be taken into account.

> Can you just confirm to us that part of that work, whilst recognising your position and the Bank’s position in relation to the need for a strong backstop leverage ratio, will take into account the special circumstances of the building societies movement particularly in both the difficulty in raising capital and of course the fact that they have low-risk asset bases.
>
> Andy Love MP, Session 2

> As I said earlier, obviously it will be important to make sure that policy clearly takes on board the types of business models that are most affected by the leverage ratio and how it operates within that, of which the concentrated mortgage lending model is the one we are talking about here.
>
> Andrew Bailey, Prudential Regulation Authority, Session 2

However, the PRA did not go as far as accepting the lower risk assertions from mutuals.

> I think we should not say that everyone has a low-risk business model. Some have moved up the risk spectrum over the years. I have never got a chief executive to actually say to me anything apart from he has a low-risk business.
>
> Martin Stewart, Prudential Regulation Authority, Session2

5.3.2 The UK regulatory and policy environment is less in tune with mutual business than in other EU countries

The Group believes that there is more of a political will in Europe to try to address these challenges on the acceptability of mutual capital than in the UK.

The impact of mutual banking in many EU countries is far greater than in the UK. The Group heard evidence about the size of the co-operative banking sector across the EU, with the most well-known banks Rabobank, Crédit Agricole, Crédit Mutuel and the German Public Bank. Depending on the country the market share can vary; in France there a market share due to three co-operative groups in the retail business of up to 60 per cent. Other important countries are Italy, Austria, Germany, Finland and the Netherlands, where there is a high market share. There are also a great number of co-operative banks in Poland, however with a smaller market share.

Since the global financial crisis, since 2008 for example, German co-operative banks increased their market share from 25 to 30 per cent. In Italy the co-operative banks, throughout the crisis, increased their financing to SMEs while at the same time the major competitors from the High Street banks rather withdrew and cut back credit lines to SMEs. Many politicians on continental Europe are well aware today of the value of a differentiated banking system with different business models and different forms of enterprise like co-operatives.

> ‘There is a general agreement that we need a differentiated banking sector and we need not only the big banks and joint stock companies but we need also mutuals and co-operative banks.’
>
> Volker Heegemann, European Association of Co-operative Banks, Session 1

5.3.3 A study of how the business environment works for mutuals in other countries should inform UK policymakers and Regulators

One recurring theme from this Group's work with Government and Regulators over the last few years has been the generally low level of understanding that has been encountered with relevant officials of the nature, purpose and operating issues of mutual businesses.

We recognise that some positive steps have been taken, for example in the PRA, with the appointment of individuals with particular experience of this sector, but this is by no means replicated across all relevant authorities. It remains true that mutuals remain a 'poor relation' of business and this has a direct and detrimental effect of their ability to compete on a level playing field with conventionally owned firms.

This contrasts with the experience of mutuals in other jurisdictions – particularly across the European Union and in North America, where mutual modes of business are better provided for by relevant authorities. It results in larger, stronger and better provided for mutuals. Group Members thought that there could be lessons learned from other jurisdictions.

> I wondered to what extent you thought if … there are clearly some significant differences in the way banks and financial services are regulated in the United States …which make that model not directly applicable here, but those essential elements, data disclosure in terms of lending activity and that obligation to lend into every community, the extent to which that might help to build a stronger case for challenger banks to emerge on the high street, not in general but also in the areas of low levels of lending.
>
> Gareth Thomas MP, Session 2

It would benefit the UK economy and business community for Government and Regulators to become better acquainted with how competitor countries work with mutuals. HM Treasury and regulators should study how comparative countries operate in this respect to learn from their experience and consider what legislative, regulatory and policy approaches may be usefully applied in a UK context.

The Group was particularly interested in the difference between the UK and some of our European neighbours in terms of the application in law and regulation of co-operative principles. Members wondered if there would be merit in establishing an international standard for mutual capital that everyone could follow, which would be able to take on board some of the better experience of the Europeans and Americans in terms of delivering such an instrument.

The Basel Committee has driven the international standards for banking and has been driven from a global banking perspective. To have that focus on mutuals I think would have great merit. What we have not actually had is an institution coming together and take ownership and delivery of that standard in the way that perhaps the Basle Committee has done that for global banking standards.

Martin Stewart, Prudential Regulation Authority, Session 2

5.4 There is greater collaboration amongst member owned businesses in Europe. The UK (regulators/businesses) should examine the reason for these trends and examine potential barriers stopping greater collaboration here

5.4.1 UK mutuals do not collaborate together sufficiently, and they should make more effort to work together to share services and build strategic alliances in order to strengthen the sector

The Group heard from several witnesses about how, in contrast to mutuals in other countries, UK mutuals do not co-operate sufficiently with one another. There is a tendency to guard organisational independence and this does not necessarily serve the needs of the members or wider customers.

> 'One thing that … does distinguish the UK from other Continental countries is that the mutuals are very much individual institutions. They do not have a framework, a network, call it what you like, that you see on the Continent, so in terms of the capacity to build solutions together, I would say that the UK is not as well-placed, frankly, as you see in other countries……Look at Germany, they have, essentially, a savings bank system with pretty strong central control and in a sense assistance.'
>
> Andrew Bailey, Prudential Regulation Authority, Session2

It also weakens the sector – whereas in many other countries, there is an active culture of collaboration that strengthens individual businesses through collective capital structures, cross guarantees and shared back office services. It cannot be ignored that the mutual sector is stronger in such countries and enjoys greater market penetration in financial services.

> I do not think it is for us to say to mutuals in this country what they do and do not have, but I would observe we have had conversations amongst ourselves over the years from time to time saying would this sector prosper better if there were more shared services, for instance.
>
> Andrew Bailey, Prudential Regulation Authority, Session2

The Group is aware of the limited nature of business collaboration between financial mutuals in the UK – for example the Newcastle Building Society offers a platform for managing shared on-line deposit-taking services, which has been quite successful, but this type of collaboration is limited.

> You do see across Europe that greater centralisation and sharing of services. Also you see in Europe greater sharing of data and information as well. Building societies and credit unions feel very reluctant to share information…but that real element of sharing is not quite in the psyche of the building societies or credit unions at the present time.
>
> Martin Stewart, Prudential Regulation Authority, Session 2

It was suggested that this may all be a cultural feature, a result of a less individualistic approach to business on mainland Europe.

> There is something about the socio-economic fabric of different societies that also helps the different business models prosper. I think regulation and legislation can play a part but there has got to be something in the fabric of society that encourages these business models to grow and prosper. We do see very great differences even within the UK.
>
> Martin Stewart, Prudential Regulation Authority, Session 2

However, the Group is unconvinced by this and believes that it is more likely to be a function of parochial self interest. There is a clear opportunity for the sector itself to improve its own situation by collaborating more readily.