



The All-Party Parliamentary Group
for Building Societies & Financial Mutuals

Fostering diversity: promoting mutuals

The All-Party Parliamentary Group for Building Societies & Financial Mutuals

Short Inquiry

July 2011

A Statement from the All-Party Parliamentary Group for Building Societies & Financial Mutuals

The purpose of the Group is to discuss and support building societies and financial mutuals.

This Short Inquiry Report was authored by Peter Hunt and Matthew Ball of Mutuo, 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 merely charged to the organisations that support the Group.

Mutuo is a not-for-profit organisation, which acts as administrative secretary to the Group, for which it is paid a fee of approximately £8,000 per annum.

Last year, the APPG received support of £6,486 from the Building Societies Association and £1,081 each from the Association of British Credit Unions, Association of Financial Mutuals, Co-operative Financial Services and the Royal London Insurance Society.

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1 The All-Party Parliamentary Group for Building Societies & Financial Mutuals Inquiry Panel

The All-Party Parliamentary Group for Building Societies and Financial Mutuals has 126 Members from both Houses of Parliament.

The Purpose of the Group is to discuss and support building societies and financial mutuals.

Listed below are all the Members who sat on the Inquiry.

Jonathan Evans MP - Chair	Cardiff North
Gareth Thomas MP	Harrow West
Adrian Bailey MP	West Bromwich West
Russell Brown MP	Dumfries and Galloway
Chris Leslie MP	Nottingham East
Rt Hon Alun Michael MP	Cardiff South and Penarth
Steve Baker MP	Wycombe
Cathy Jamieson MP	Kilmarnock and Loudoun
Baroness Maddock	
Rt Hon Lord Naseby	

2 Terms of Reference

The All-Party Group agreed the following terms of reference for this short inquiry.

1. How can the Government best develop a policy strategy to implement the Coalition's commitment to promote mutuals?
2. Should the new financial regulators also have a responsibility to promote corporate diversity and promote mutuals? If so, how would this work?
3. How can the Bank of England help to develop an approach that supports this policy objective?
4. Is the legislative framework for financial mutuals adequate?
5. In what other ways could the Government engage with mutual businesses to improve the corporate diversity of financial services providers?

3 Introduction

On 12 May last year, the Conservatives and Liberal Democrats published the Coalition Agreement setting out a programme for partnership over the next five years. The Agreement was regarded as good for the mutual sector. Specifically, the Coalition Agreement said:

“We want the banking system to serve business, not the other way round. We will bring forward detailed proposals to foster diversity in financial services, to promote mutuals and to create a more competitive banking industry”.

It was this commitment to foster diversity in financial services that we wanted our Short Inquiry to concentrate upon. We focused specifically, in the context of the terms of reference of this inquiry, on what is being done to implement the Coalition’s commitment to the promotion of mutuals.

We are very much aware of what has taken place in relation to the Vickers report since we started our Inquiry back in November last year, but our interest is in examining exactly what is going on in terms of promoting diversity and particularly in terms of fostering the mutual sector. The Inquiry has exposed the difficulty mutuals have in competing in equal terms with shareholder-owned companies, due to the weight of legislative and regulative bias against the mutual model.

Evidence was taken in select committee style in three sessions. Invitations were extended to witnesses from the existing financial mutual sector, the Financial Services Authority and the Government. All oral evidence was recorded verbatim. We also invited organisations to submit written evidence; a list of witnesses is recorded in the appendix to 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 Inquiry and to members of the Group. The Inquiry makes a number of recommendations and we will pursue these with the Government.

Jonathan Evans MP, Chairman

June 2011

4 Executive Summary

How can the Government best develop a policy strategy to implement the Coalition's commitment to promote mutuals?

The Group accepts that the Coalition Government has been in power for just over a year and so there are limitations to how easily one can gauge their success in promoting mutuality over such a limited period of time.

However, from the evidence given to the Inquiry, it is clear that the Government has not yet developed a clear strategy to promote mutuals.

The Inquiry found that the Government appears to have concentrated its policy efforts on encouraging the development of new mutuals to provide public services rather than to support the existing financial mutual sector.

The Inquiry was convinced that the existing mutual sector would like to help the Government to deliver its policy agenda, but in return it would require continuing practical help and support from the Government to maintain and enhance existing mutual businesses.

Members heard that building societies had benefitted over the last twelve months from a positive working relationship with HM Treasury and FSA officials, which it is hoped will yield positive results on the search for new capital instruments.

At the same time, mutual insurers and friendly societies have reported that they face serious threats to their future as a result of the FSA's attitude to their sector, and HM Treasury's apparent unwillingness to engage with them.

Evidence from both the FSA and HM Treasury witnesses has done nothing to contradict the impression that insufficient support is being provided to this crucial part of the mutual sector.

The All-Party Group takes note of the Government's initiatives so far, but is not convinced that the Government has so far been able to articulate a clear vision for promoting mutuals.

This Group has therefore concluded that:

- **HM Treasury appears to have taken a reactive stance to the mutual sector – beginning to deal with important issues such as building society capital, but little else of substance.**

And recommends that:

- **It is imperative that the Coalition urgently adopts a comprehensive policy strategy to implement its Coalition Agreement commitment to promote mutuals.**
- **HM Treasury should act as a strong advocate for mutual businesses, in particular in its dealings with the Financial Services Authority and subsequent new regulatory authorities.**
- **HM Treasury should pro-actively promote the interests of financial mutuals within Government, and ensure that balance is given to understanding and promoting mutuals across all Government departments**

Should the new financial regulators also have a responsibility to promote corporate diversity and promote mutuals? If so, how would this work?

The Financial Services Authority is established under the Financial Services and Markets Act of 2000, which set out its four statutory objectives. The Inquiry heard evidence from the FSA Chief Executive that the FSA did not consider it was responsible for promoting any business form over another. Governed as it is by the narrow statutory responsibilities as set out in the Act, it is not currently able to foster corporate diversity and foster mutuals.

The Group concluded that this situation is a barrier to the effective implementation of current Government policy; it is not possible to divorce the actions and behaviour of the regulatory authorities from the policy objectives of Government – both should work in harmony.

The Group notes the Coalition's intention to reform the current system of financial regulation. The current system – which shares responsibility for financial stability between the Treasury, the Bank of England and the Financial Services Authority (FSA) – will be replaced with a new system, and the FSA will cease to exist in its current form.

HM Treasury states that,¹
 'The legislation to implement the reforms will establish a Financial Policy Committee (FPC) in the Bank of England with a dedicated focus on identifying and managing macroeconomic and other risks to the stability of the financial services sector. It will also create a new Prudential Regulation Authority (as a subsidiary of the Bank of England), responsible for the day-to-day prudential supervision of financial institutions, and a Financial Conduct Authority (FCA) with responsibility for the conduct of all financial services firms.'

The Group therefore sees this new legislation as an opportunity to establish new duties for financial regulators that would ensure that they promote corporate diversity and promote mutuals. The Government should ensure that there are clear duties established for the new regulatory authorities to do this. The Inquiry also heard from some witnesses, that on a day to day level, relations with the Financial Services Authority could be improved. Again, there is a perception that there is an inherent bias, at least in understanding, towards the plc business model. Notably, the Inquiry heard, and accepted, that progress had been made in the FSA in their relationship with building societies through the creation of a dedicated building societies directorate. But worryingly, the same attention had not been given to regular dealings with

the mutual insurance and friendly society sector.

The Group was not satisfied with the reasons given by the FSA for this lack of attention to the needs of this part of the sector and calls upon the Regulator to ensure that sufficiently expert and engaged senior staff work with mutuals to ensure good regulation follows.

The Group recommends that:

- **Legislation establishing the new regulatory authorities must include 'Promoting mutuals and fostering diversity' within the statutory objectives.**
- **Moreover, Regulators should be statutorily committed to take account of diverse business structures.**
- **An overall Head of Mutuals policy should be appointed at the newly formed PRA.**
- **Whilst acknowledging recent improvements at the FSA, a person with similar experience to the Head of the Building Societies Directorate in the FSA should also be appointed to a mutuals insurance directorate in the new PRA to establish better links and understanding with mutual insurance companies and friendly societies.**
- **Regulation needs to be proportionate, taking account of the relative risks posed by the business. Regulation should therefore be risk-based so as not to create a disproportionate burden on mutuals, large and small.**
- **The Government should intervene in the current impasse between mutual insurers and the FSA over capital issues. HM Treasury should first press the FSA to seek a second legal opinion on the issue of with profits capital funds. If it is not prepared to do so, Treasury should seek its own advice, in order to properly inform its policy responsibilities.**

¹ http://www.hm-treasury.gov.uk/fin_stability_regreform_structure.htm

How can the Bank of England help to develop an approach that supports this policy objective?

The development of a new regulatory framework provides an opportunity to improve the regulatory relationship with the mutual sector and ensure that it is fit for purpose in delivering appropriate regulation, in line with government policy.

The Group agrees that in order for the Government to achieve its aim of enhancing corporate diversity, it needs to measure the degree of corporate diversity over time so that progress can be measured, and assurance can be given that the risks of a future credit crisis are indeed being reduced over time.

The Inquiry was keen to learn more about how a diversity index might work in practice and whether it needed to be government-owned. The possibility was raised of it being simply government-endorsed and coming from across the whole of the financial services sector itself.

The Inquiry heard that it is considered vital by the mutual sector that the Bank should be required to explain decisions in relation to mutuals on each regulatory role, and the impact of new regulation on diversity must be carefully assessed. It is anticipated that this is likely to be reflected in the new legislation.

The Group was pleased that the FSA agree that there are a number of high-level reasons why diversity of the business model within the financial system brings advantages to its objectives.

It is therefore a little surprised that the FSA has not yet considered how it would measure corporate diversity changes over time.

The Group recommends that:

- **A Government endorsed 'Diversity Index' should be established across the whole financial services sector.**
- **This measurement exercise should be undertaken at regular intervals, and the findings should be published in a timely manner.**

- **The Bank of England should be required to report on diversity in the financial services sector, producing an annual review of diversity and how its actions have at least maintained it and, if possible, increased it.**

Is the legislative framework for financial mutuals adequate?

Legislation affecting mutuals sits in a number of sector specific Acts of Parliament, such as the Building Societies Act, Friendly Societies Act and Industrial & Provident Societies Act. In addition, many mutuals are registered under the Companies Act.

It is possible to trace the origins of much of this legislation to the 19th Century, with many principles established at that time remaining in force today. Of course, the legislation has been modernised many times since its inception, but the fractured nature of legal frameworks affecting mutuals has inevitably led to a time lag in updating law to keep pace with innovations in mainstream company legislation.

One focus of the Mutuals Manifesto² was to suggest that mutual sector legislation is regularly updated to ensure a level playing field with companies. This will require HM Treasury to operate a 'trigger' procedure for updating mutuals legislation when company law changes are considered. This will necessitate close collaboration with the Department for Business, Innovation and Skills, which is responsible for company law.

In their evidence to the Inquiry, the trade bodies for financial mutuals believe that there are mundane but important issues such as the updating of the electronic communications with members' regulations that need to be considered.

There are also issues relating to the Mutuals Societies Transfers arrangements (known in the sector as the Butterfill legislation) and the extent to which different types of mutuals can merge with one another.

The Group recommends that:

- **HM Treasury should operate a formal ‘trigger’ process to ensure that legislation for financial mutuals keeps pace with where appropriate, and is given the same priority as, company law reform.**
- **Legislation should be brought forward to enable all types of mutuals to merge, as envisaged under the ‘Butterfill Act.’**
- **HM Treasury should work with the mutual insurance sector to agree legislative changes that will enable them to invest more flexibly in the public interest.**

In what other ways could the Government engage with mutual businesses to improve the corporate diversity of financial services providers?

The focus of this part of the Inquiry was to examine the interface between Government and the financial mutual sector, and to explore other practical opportunities for promoting mutuals.

Clearly, witnesses from the mutual sector had reported what they described as a lack of sufficient thought from HM Treasury and the Financial Services Authority in their dealings with mutuals.

As a Group, we can conclude that this appears to be caused, at least in part, by a lack of clarity and status being given to matters affecting mutuals. Although the Financial Secretary is responsible for dealing with mutuals on a regular basis, this is in addition to his many other responsibilities.

The Group is also concerned about the effect that Government bail-outs have had on competition in the mortgage and savings market, where those institutions that have failed have received significant taxpayer support and have now become more dominant in the market.

The banking crisis highlighted the importance to the UK economy of retaining diverse models of financial service providers. Mutuals, though affected by the downturn, have been more stable than proprietary banks.

Given the difficulties in setting up a new mutual of any size in the deposit-taking sphere, it makes sense

to explore the re-mutualising of a mature ex-mutual business, as well as conserving remaining mutuals.

The new mutual could be either a building society or another type of financial mutual.

Crucially, the new mutual should have an asset lock that ensured members only benefited from their ongoing financial relationship with the business.

Either a new mutual could achieve this objective of locking in the value of the business to avoid a future repeat of Northern Rock’s behaviour or a new building society could be created with its rules automatically incorporating charitable assignment.

The Group believes that by this action, the Government would send a strong signal that it supports institutions that do not take unnecessary risk.

The Group believes that the Government is faced with clear choices, and notes with disappointment the Chancellor’s Mansion House speech, in which he stated the Government’s aim to sell Northern Rock. Ultimately, this may be the right decision, but it can only be made once the option of re-mutualising Northern Rock has been fully evaluated. This has clearly not yet happened.

The Group recommends that:

- **There should be a dedicated Government Minister for Mutuals in HM Treasury - similar in status to the Minister for the City who would be able to deal across the various government departments that have to deal with the mutual sector.**
- **The Treasury should ensure that its actions to stabilise the financial system do not inadvertently skew competition in the market and provide advantages to failed financial services businesses in public ownership.**
- **The Government should fully consider remutualising Northern Rock, and publish the advice that it has received in relation to this matter.**

5 The Financial Mutual Sector Today

Mutuals have been a major part in the UK's financial services sector for a long time and financial mutuals now serve one in three of the population.

In every UK constituency there are likely to be a number of mutuals operating, bringing employment to the area and access to financial services for consumers that would otherwise be not served.

The financial mutual sector in the UK consists of building societies, mutual insurers, friendly societies, other financial mutuals and credit unions.

Building Societies

There are 53 mutual lenders and deposit takers in the UK including 48 building societies. They hold assets of over £365 billion and have approximately 27 million members.

Building Societies are owned by their customers rather than shareholders. This gives them a fundamental advantage over publicly listed companies such as banks in that they do not have to pay any dividends. Instead, mutuals are able to pass surpluses on to their members by employing lower mortgage rates and higher savings rates. This ownership structure also means that providing excellent customer service is at the heart of a mutual's business model because they are not only providing services to their customers but also their owners.

A survey conducted³ in 2010 revealed that 59% of savers at mutual institutions were either extremely or very satisfied with their provider compared to just 47% savers with other institutions. It also found that 70% of borrowers at mutual institutions were extremely or very satisfied with their lender, compared to 63% of borrowers with other organisations. In addition, the survey found that mutuals outperformed their competitors in eleven specific areas of customer service ranging from value for money to being supportive when customers face financial difficulties.

³ 'Customer service at mutuals is better than at banks,' BSA April 2010

Mutual Insurers and Friendly Societies

There are around 200 of these organisations in the UK. The Association of Financial Mutuals has 57 members and represents mutual insurers and friendly societies in the UK. Between them, these organisations manage the savings, protection and healthcare needs of 20 million people, and have total funds under management of £80 billion.

Many AFM members can point very clearly to their innovative approach to business, which sees financial mutuals being the leading providers of child savings, the leaders in stakeholder pensions, the primary providers of basic advice, the companies most likely to pay insurance claims and to lead performance tables.

Other Financial Mutuals

Some financial mutuals do not easily fit into the various categories that have developed over the years, perhaps because they have different legal structures, or because they are hybrid structures. Two examples of these are The Co-operative Financial Services (a new type of business created following the merger of Britannia Building Society with The Co-operative Financial Services) and Simplyhealth.

These two organisations alone have assets of over £70 billion and 2.6 million members.

Credit Unions

There are 454 credit unions in the UK holding assets of over £703 million, with just over 760,000 members.

Credit unions provide ethical, not-for-profit, financial services to communities and workplaces across Britain. As well as the core functions of providing safe savings which pay a dividend and affordable credit - charged at a rate of not more than 26.8% APR - credit unions are providing an increasingly sophisticated range of products. Services include the Credit Union Current Account, Individual Savings Accounts (ISAs), insurance and mortgages.

6 The case for financial diversity and promoting mutuals

The financial services sectors of all countries are characterised by a degree of diversity in terms of ownership types and business models. This variety of business models creates a corresponding diversity in forms of corporate governance; risk appetite and management; incentive structures; policies and practices; and behaviours and outcomes. It also offers wider choice for consumers through enhanced competition that derives in part from the juxtaposition of different business models.

The diversity of ownership forms and business models, generally includes a balance between public and private ownership, with the private sector being distributed between shareholder-owned plcs, other private ownership such as private equity, and a range of 'stakeholder ownership' models including co-operative banks, mutuals and credit unions, which are included within the generic term 'mutuals'. Mutuals are competitive players in the financial services sector and act to drive competition in the market, benefiting customers through lower prices and a greater choice of providers.

The Centre for European Policy Studies (CEPS) produced two major and comprehensive research studies of diversity in European banking (CEPS, 2009 and 2010). Both reports emphasise the advantages of having diversity in banking structures and models, and illustrate this with case studies of several countries. The purpose of these reports is not to argue that one model is superior to others, but precisely that advantages accrue through diversity. Their first report, *Investigating Diversity in the Banking Sector in Europe* found that 'The most important conclusion is that the current crisis has made it even more evident than before how valuable it is to promote a pluralistic market concept in Europe and, to this end, to protect and support all types of ownership structures'.

Thus, the argument is that in a situation of uncertainty and unpredictability, we cannot know which model will

prove to be superior in all possible future circumstances, so we ought to be rather cautious before destroying any successful corporate forms.

However, the UK financial services sector is dominated disproportionately by a single business model, namely the large, shareholder-owned plc. This domination of the shareholder ownership model - whose purpose is to maximise financial returns to the shareholders - proved a lethal combination with the financial deregulation, the creation of new financial instruments and the concomitant rising levels of debt over the past twenty years. Ever greater risks were taken to drive up financial returns and 'shareholder value', culminating in the global credit crunch of 2007-2008 which in turn created the first global recession since the 1930s, during 2008-2009, from which the UK and global economies are only slowly recovering.

The credit crunch, which to a significant extent was caused by the activities of private sector banks, resulted in the UK Government giving them a bailout of perhaps £80bn. Given the financial, economic and social costs of that credit crunch and concomitant recession, a key priority for policy needs to be to put in place measures to prevent a reoccurrence in the future.

In a situation of uncertainty and unpredictability, we cannot know which model will prove to be superior in all possible future circumstances, so we ought to be rather cautious before destroying any successful model. The global economy is a complex system. An important point about complexity is that many complex systems are intrinsically unpredictable, even if we know everything else about them. Thus, the problem is not just that the economic future is uncertain, but that it is fundamentally unpredictable. As *The Economist* notes:

Just as an ecosystem benefits from diversity, so the world is better off with a multitude of corporate forms. (*The Economist*, 2010, p. 58)

In a speech delivered at the Financial Student Association in Amsterdam in April 2009, Andrew Haldane, Executive Director, Financial Stability, Bank of England, makes interesting observations on this point:

"In explaining the collapse in fish and finance, lack of diversity seems to be a common denominator. Within the financial sector, diversity appears to have been reduced for two separate, but related, reasons: the pursuit of return; and the management of risk. The pursuit of yield resulted in a return on equity race among all types of financial firm. As they collectively migrated to high yield activities, business strategies came to be replicated across the financial sector. Imitation became the sincerest form of flattery.

"So savings co-operatives transformed themselves into private commercial banks. Commercial banks ventured into investment banking.....

"Finance became a monoculture. In consequence, the financial system became, like plants, animals and oceans before it, less disease-resistant. When environmental factors changed for the worse, the homogeneity of the financial eco system increased materially its probability of collapse."

The UK context: a lack of diversity

For the market as a whole to benefit requires that the various corporate models each enjoy the necessary critical mass, defined as the degree of market share necessary to enable that model to operate successfully and thus to provide real competitive pressure on the other players within the market. Other European countries tend to have several co-operative banks, which tend to be important lenders to the SME sector, whereas in the UK there is only one. The UK's 500 credit unions have total assets of around half a billion pounds - far short of what would be necessary to provide serious competitive pressure on the high street banks. The mutual insurance sector in the UK, at 5 per cent of the total insurance market, compares badly to the 30-40 per cent typical of the other large insurance markets globally. And the demutualisations of the 1980s and 1990s reduced the mutual building society sector

significantly in size. A similar spate of demutualisations happened in the mutual insurance sector and the impact on policyholder returns, levels of service and fairness for customers has been equally detrimental.

There is a fundamental attitude problem within the UK amongst the media and regulators, with the shareholder owned company being regarded as the 'normal' or 'natural' way of doing business. Other ownership models may be accepted, yet all models tend to still be judged against criteria appropriate for the shareholder ownership model. And the large plc, at that. Thus, for example, on the issue of raising capital, the Financial Services Authority (FSA) have appeared, at times, to view all companies as if they were, or should be, large plcs.

7 The Inquiry

7.1 How can the Government best develop a policy strategy to implement the Coalition's commitment to promote mutuals?

'We want to ensure that there is room for diverse providers of financial services to flourish in a fair and competitive market. Building societies, friendly societies, mutual insurers, co-operatives and credit unions all have long traditions of providing an alternative to shareholder owned business and provide choice and competition that is valued both by consumers and by the Government.'

Rt Hon Danny Alexander, Chief Secretary to the Treasury, September 2010

The All-Party Group accepts that the Coalition Government has been in power for just over a year and so there are limitations to how easily one can gauge their success in promoting mutuality over such a limited period of time.

The Group also acknowledges the publication of the Draft Financial Services Bill. However, the Group feels it is important that it examines any evidence of a policy framework for implementing the Coalition's commitment to mutuals. From the evidence given to the Inquiry, it is clear that the Government has not yet developed a clear strategy to promote mutuals.

A year plus into the new administration we have seen little more than the finishing off of business started by the previous government, which itself was not strategic in its approach to mutuals. The Government needs to have firm targets in place to evidence its Coalition commitment to promote mutuals.

The Inquiry heard of the frustration felt in the mutual sector that, so far, there was little sign of a coherent Government strategy in place to implement the Coalition Agreement commitments. Both trade bodies for leading financial mutuals, the Association of Financial Mutuals and the Building Societies Association, expressed the opinion that the Government could be doing a lot better in their commitment to promote mutuals.

Martin Shaw for the Association of Financial Mutuals said,

"We have seen lots of warm words of encouragement from the Government and we are starting to see some level of engagement around the detail. If we are honest, scoring it out of ten, I would be loath to give you a score, but it would not be in the high factor yet because so much of what we have discussed has yet to actually materialise into anything substantive."

He explained that most of the policy focus on mutuals from the Government so far has been concerning the possibility of mutualising areas outside of financial services such as a range of public services or in the context of welfare reform or the Post Office. He hoped that by a process of exploring the wider issues around mutuality then the Government can find that there is a real opportunity for financial services to benefit from that increased interest in the sector as well.

Adrian Coles for the Building Societies Association, "We were very pleased to see the commitment on the part of the Coalition to fostering diversity and promoting mutuality when the Coalition was formed in May."

He went on to add that;

"Having said that, we would very much want this Government to show enthusiasm for the new forms of capital that we are trying to develop in the building society and co-operative bank sectors. I would give them

at the moment probably seven out of ten for the warmth of their rhetoric towards the sector. We will move up to the eights and nines when they actually deliver practical change emerging from that rhetoric.”

The Inquiry notes that the Government does indeed appear to have concentrated its policy efforts on encouraging the development of new mutuals to provide public services rather than to support the existing financial mutual sector.

The Inquiry was convinced that the existing mutual sector would like to help the Government to deliver its broader policy agenda, but in return it requires continuing practical help and support from the Government to maintain and preserve existing mutual businesses.

The All-Party Group is aware that the mutual sector has a track record of helping the Government deliver its policy agenda as it did when Child Trust Funds were developed by the previous administration. Mr Shaw (AFM) was keen to state that this was still the prevailing attitude among the mutual institutions that he represents.

He stressed that the AFM’s approach to HM Treasury is to see how it can find solutions rather than problems; how it can help government to develop and deliver on its own solutions rather than going cap-in-hand and making demands from the government. For example, he referred to one initiative,

“We have around £80 billion in assets across the mutual insurance sector. We have been talking to the Treasury about how there may be other options for us to invest in longer term vehicles which might therefore also help government with some of the issues that it is trying to grapple with, such as where you fill the void in infrastructure investments if the government no longer has the money to invest in those kinds of things.”

The AFM in its evidence, stated that it had been presenting ideas to Government that perhaps there is a role there for mutual insurers to help work alongside government to, for example, outsource some of the current elements of the welfare state through to the mutual insurance sector. They cited statutory sick pay

as something which could just as easily be an insurance solution as it is paid by the state.

At the same time, the Inquiry heard in detail of particular problems currently being faced by the mutual insurance sector. Mutual insurers and friendly societies have reported that they face serious threats to their future as a result of the FSA’s attitude to their sector, and HM Treasury’s apparent unwillingness to engage with them.

Evidence from both the FSA and HM Treasury witnesses did nothing to contradict the impression that insufficient support is being provided to this crucial part of the mutual sector.

More positively, Members heard that building societies had benefited over the last twelve months from a more positive working relationship with HM Treasury and FSA officials, from which it is hoped will yield positive results on the search for new capital instruments.

The All-Party Group put these misgivings directly to HM Treasury when at the Third Session of the Inquiry, the Minister with responsibility for financial mutuals, Mark Hoban MP, Financial Secretary to the Treasury gave evidence.

In his opening statement, he said,

“The Coalition Agreement did commit to increase diversity for financial services. I think we have taken a number of measures over the course of the last 364 days in delivering that commitment, but clearly we have another four years and one day to go in this Parliament and there is more work that we need to do.”

The Minister highlighted some of the actions the Government has taken since it came into office:

- It has worked very closely with the building society sector to look at ways in which it can help to modernise the legislative framework.
- Parliament made an order last month to enable friendly societies to communicate electronically with their members.
- The Government is very conscious of the importance played by the building society sector on new forms of

capital instruments to enable them to manage their capital and to provide capital for future expansion. The Treasury is working very closely with the sector and the FSA to ensure that there is proper provision in CRD4, for an instrument that reflects the nature and reality of mutuality and will enable mutuals to raise more capital.

- The Government will be bringing forward as part of the Financial Services Bill further modifications to enable a floating charge to be granted over the assets of building societies to be able to participate more effectively in payment systems.
- HM Treasury is going to re-lay shortly the Legislative Reform Order, which would modernise the framework for credit unions to enable them to pay interest on accounts and enable them to have a more permissive common bond to expand their services.

Mr Hoban added,

"There is a range of measures we have taken, or are taking at the moment, to promote diversity but I am sure there is more that we can do. I am very keen to work closely with the mutual sector so that where they identify legislative barriers to their growth and expansion we can take action to tackle those where there is a robust case for doing so."

The Minister was keen to see a growth in the credit union sector and underlined this when he said:

"We do need to look at what Government can do to encourage mutuals to grow. A topic that I have discussed with my ministerial colleagues in DWP and BIS is how we can support the credit union sector to grow, both in terms of support to grow funds through exploring to what extent the use of the Post Office as a platform for credit unions and also the LRO (Legislative Reform Order). In that sort of situation we can see a sector that has the potential for growth that Government can help and exploit."

Members heard that it is not easy to create new financial mutuals. During the Inquiry Mr Hoban was asked if the Government had any plans to dismantle the barriers to the creation of new financial mutuals.

Mr Hoban responded that the Government is keen to see more competition in the financial services sector.

"That is one of the areas Sir John Vickers had been asked

to look at in his work on the structure of the banking sector and it is also something that the Treasury Select Committee has looked at."

The Government accepts that it is quite difficult for new mutuals to be created, particularly in the building society sector. It is easier for new credit unions to be formed and the Minister further commented that, "I think there are ways in which people can come together to insure risk that does enable new mutual insurers to be created but not in a way necessarily that falls within the remit of legislation or regulation."

The Minister also stressed that,

"We have seen a situation where a number of institutions of varying sizes have collapsed leaving costs to be picked up through the FSCS and in other ways. We do need to get that balance right between encouraging new entrants and also having an eye on our financial stability."

The All-Party Group takes note of these Government initiatives, but is not convinced that the Government has so far been able to articulate a clear vision for promoting mutuals.

This Group has therefore concluded that:

- **HM Treasury appears to have taken a reactive stance to the mutual sector - beginning to deal with important issues such as building society capital, but little else of substance.**

And further recommends that:

- **It is imperative that the Coalition urgently adopts a comprehensive policy strategy to implement its Coalition Agreement commitment to promote mutuals.**
- **It is consistent with Government policy that HM Treasury should act as a strong advocate for mutual businesses, in particular in its dealings with the Financial Services Authority.**
- **HM Treasury should proactively identify areas in which mutuals may be part of the solution to Government initiatives and policy developments.**
- **HM Treasury should pro-actively promote the interests of financial mutuals within Government, and ensure that balance is given to understanding and promoting mutuals across all Government departments**

7.2 Should the new financial regulators also have a responsibility to promote corporate diversity and promote mutuals? If so, how would this work?

The Inquiry heard that there is a commonly held view within the financial mutual sector that regulators behave as if they do not understand mutuals. It is claimed that regulation is too often designed to deal with plcs without dealing with the specific needs and differences of mutuals. The Inquiry was keen to find out if this was indeed the case and, if so, how things could be improved in this area.

The Financial Services Authority is established under the Financial Services and Markets Act of 2000, which set out its four statutory objectives.

The Financial Services and Markets Act 2000 established the Financial Services Authority and sets out its four statutory objectives

- market confidence - maintaining confidence in the UK financial system;
- financial stability - contributing to the protection and enhancement of stability of the UK financial system
- consumer protection - securing the appropriate degree of protection for consumers; and
- the reduction of financial crime - reducing the extent to which it is possible for a regulated business to be used for a purpose connected with financial crime

The Inquiry heard evidence from the FSA Chief Executive that the FSA did not consider it was responsible for promoting any business form over another. Governed as it is by the narrow statutory responsibilities as set out in the Act, it is not currently able to foster corporate diversity and promote mutuals.

The Group concluded that this situation is a barrier to the effective implementation of current Government policy; it is not possible to divorce the actions and

behaviour of the regulatory authorities from the policy objectives of Government - both should work in harmony.

The Group notes the Coalition's intention to reform the current system of financial regulation. The current system - which shares responsibility for financial stability between the Treasury, the Bank of England and the Financial Services Authority (FSA) - will be replaced with a new system, and the FSA will cease to exist in its current form.

HM Treasury states that,⁴

"The legislation to implement the reforms will establish a Financial Policy Committee (FPC) in the Bank of England with a dedicated focus on identifying and managing macroeconomic and other risks to the stability of the financial services sector. It will also create a new Prudential Regulation Authority (as a subsidiary of the Bank of England), responsible for the day-to-day prudential supervision of financial institutions, and a Financial Conduct Authority (FCA) with responsibility for the conduct of all financial services firms."

The Group therefore sees this new legislation as an opportunity to establish new duties for financial regulators that would ensure that they promote corporate diversity and promote mutuals. The Government should ensure that there are clear duties established for the new regulatory authorities to do this.

The Inquiry also heard from some witnesses, that on a day to day level, relations with the Financial Services Authority could be improved. Again, there is a perception that there is an inherent bias, at least in understanding, towards the plc business model. Notably, the Inquiry heard, and accepted, that progress had been made in the FSA in their relationship with building societies through the creation of a dedicated building societies directorate.

⁴ http://www.hm-treasury.gov.uk/fin_stability_regreform_structure.htm

The BSA felt that that the creation of a single building society department within the FSA over the last three years had been an improvement. But worryingly, the same attention had not been given to regular dealings with the mutual insurance and friendly society sector.

Although there is a greater understanding of building societies now at the mid-management level, especially in the FSA; the problem is at the very top level where there has been a lack of understanding and a lack of appreciation of the mutual model.

Adrian Coles (BSA) said,

"At the same time there is a sort of generally warm cuddly feeling towards the mutual model, but it is not always being backed by practical assistance at the policy level."

The Group was not satisfied with the reasons given by the FSA for this lack of attention to the needs of this part of the sector and calls upon the Regulator to ensure that sufficiently expert and engaged senior staff work with mutuals to ensure good regulation follows.

The Group therefore supports the implementation for and by the Prudential Regulatory Authority of a strategy for financial diversity⁵

- **Within the new regulatory framework, there needs to be a clear responsibility in the regulator's charter to promote diversity of ownership**
- **The regulator needs to have somebody within the organisation who is at a senior level defined as a head of mutuals policy and who is therefore charged with demonstrating that regulation does not prevent mutual organisations from competing on an equal basis with non-mutual forms.**
- **Regulation needs to be proportionate. Regulations and the demands it makes represents a powerful competitive advantage for large incumbent players because they can absorb that cost. The resource costs impact more heavily on smaller players, constituting a barrier to entry - all new entrants have to comply with regulation before beginning business - and it makes it more difficult**

for the smaller mutuals to thrive in a way that would provide meaningful competition to the big incumbents.

The Inquiry was keen to learn the Government's view on whether the FSA should have a role in promoting corporate diversity and mutuals and whether there would be any changes as a result of the new restructuring of UK's financial regulation.

The Government stressed that in its proposal to significantly restructure the regulation of financial services in the UK, it had proposed that in any cost benefit analysis the two new regulators should explicitly address the impact of the changes on the mutual sector to ensure that there is a recognition of the impact that changes could have on it.

The Minister stated,

"I noted from the evidence that Mr Sants gave that there is also recognition in the FSA currently that they need to be neutral towards mutuals and thinking in the new structure how the interests of mutuals are properly looked after."

The Government White Paper on regulatory reform that was published in July 2010 makes it clear that there will be a disproportionate cost to be faced by smaller mutuals, small building societies, friendly societies and credit unions. For smaller institutions that are mutuals, they will find the costs associated with the new regulatory regime more onerous than the larger institutions.

The BSA also confirmed the point that in the past they had seen regulatory solutions being designed for the plc sector and with the mutual sector added as an afterthought, rather than the mutual sector seen as equivalent but different to the plc sector.

Adrian Coles added:

"I would not say the FSA is a promoter of the mutual sector. It would probably say that it is trying to be fair and even-handed across all types of institution. I would think it probably does not devote sufficient very high-level resource to thinking about the mutual sector compared to the plc sector. It will probably say that is because the plc sector is larger but, on the other hand, if we are going to

promote diversity and to foster growth of mutuality as the Coalition wants then that has to change within the new regulatory arrangement.”

For the FSA Mr Sants was keen to stress that FSA's attitude to mutuals:

‘We certainly do take the view that the FSA certainly sees the mutuals as a very important and vibrant part of the financial sector and we recognise the importance of giving due consideration to how they should be regulated going forward.’

A strategy for financial diversity ⁶

Within the new regulatory framework, there needs to be a clear responsibility in the regulator's charter to promote diversity of ownership.

The PRA needs to have a person within the organisation who are at a senior level defined as a head of mutuals policy and who is therefore charged with demonstrating that regulation does not prevent mutual organisations from competing on an equal basis with non-mutual forms.

Regulation needs to be proportionate. Regulations and the demands it makes represents a powerful competitive advantage for large incumbent players because they can absorb that cost. The resource costs impact more heavily on smaller players, constituting a barrier to entry - and it makes it more difficult for the smaller mutuals to thrive in a way that would provide meaningful competition to the big incumbents.

On the new Regulatory authorities:

- i) ‘Promoting mutuals and fostering diversity’ needs to be in their objectives.
- ii) They should both be committed to take account of diverse business structures.
- iii) There needs to be a mutuals’ policy function in both the FPC and the PRA: these bodies need somebody on the inside who understands the difference at the grass roots of producing policy in diverse sectors.

Hector Sants confirmed that he did not plan to make changes to the personnel structure in the remaining stage of life of the FSA. He reminded Members that the FSA currently has a designated individual responsible for building societies and said that it was his intention that in the new PRA he will also make sure that it designates an individual responsible for the life insurance mutual component too.

The All-Party Group also wanted to know if the FSA would support the idea of regulatory authorities specifically assessing the impact of new regulatory proposals on mutuals.

FSA witnesses stated that the vast majority of rules which are applied to prudential issues are not made by the FSA, but emanate from Europe. But where the FSA was making any rules which were solely within its control, it already has an obligation to do a thorough cost-benefit analysis/impact analysis which includes looking at the different types of business model which that rule would be impacting on.

Mr Sants went on to say that:

“Reinforcing that obligation includes looking at the mutual business model and is a wholly reasonable statement to make, and we already do it, but it is reasonable that you have reminded us, in the light of the Coalition's objectives, that we should be doing that, and I believe we do that.”

The Inquiry raised this point again with the Financial Secretary when he was asked for his views on whether there is a possibility that the cost and complexity of the regulatory reforms would reduce diversity and affect competitiveness particularly in some of the smaller mutuals?

The Minister replied:

“That is an important point. It is something that I am very clear about and I am clear in my own mind that there should be a relationship between the complexity and risk an institution poses and their share of the cost of regulation.”

He went on to confirm that the PRA will make it very clear that their approach may not reduce the burden

⁶ Michie, J: Promoting Corporate Diversity in the Financial Services Sector, Oxford University Sept 2010

of regulation but there will be a very clear recognition of the relationship between the size and complexity of supervisory intervention.

The Government currently envisages putting the new regulatory architecture in place by the end of 2012. In the interim period, the Bank of England and the FSA will continue with the detailed design of the PRA's new operating framework. The Bank of England and the FSA will publish further detail on the PRA's regulatory and supervisory processes, its strategic priorities and its business plan ahead of the formal transfer of responsibilities.

Mutuals and Capital

Both Building Societies and Financial Mutuals are actively dealing with issues related to capital within their member societies.

The FSA reported that the one of the challenges that the mutual model was facing was around the difficulty of introducing fully loss-absorbent capital. The Inquiry wanted to know what the FSA was doing to dismantle barriers to enable such new forms of mutual capital to emerge.

According to FSA witnesses,

"We are currently operating under one set of CRD rules that do not readily allow, in our judgement and in the judgement of the building society movement, the design of an instrument which both can be counted as fully loss-absorbent within the European Directives and also can be readily marketable."

The FSA, the Industry and the Treasury are currently continuing to work on an instrument that will be compliant with the forthcoming EU Directive.

The FSA has sought to have that Directive modified for the future, as long as it can be suitably ring-fenced to the mutual sector. Proposals have been made by the Treasury and the FSA has advised the Treasury in seeking to get those amendments in CRD4.

Martin Stewart from the FSA added:

"I think we also do recognise that there is the theoretical

ability to create a capital instrument in CRD4, and we indeed also recognise the question of whether investors will actually be prepared to buy that instrument when it could come to market. The work we have done with the building societies and investors over the last six months is to look at the type of instrument which investors could look to buy when CRD4 comes in, and that has formed the basis of our recommendations to Treasury."

The Inquiry heard in some detail about the mutual insurers and friendly societies' experience of dealing with the FSA. It is clear from his evidence that their recent experience of the FSA has not been a positive one.

Mr Shaw confirmed that the AFM has been talking to the FSA now for a period of about four years on issues of capital in mutuals, beginning when the FSA was making changes to its rule book. The AFM identified that some hard-won exemptions that had been put in place for mutuals were lost as part of that process.

'When their new rule book was issued, it specifically excluded the elements of the with-profits rule book which made the whole mutuals model make sense.'

The AFM has now been in detailed discussion with the FSA to try to highlight the implications of this change, and this discussion culminated in a 'Dear CEO' advice letter written by the FSA to all of the chief executives of mutuals with a with-profits fund in October 2009.

Mr Shaw said,

"All of those organisations were given until the end of year to form a response and all of them duly did so. A small number of our members have had a response from the FSA but the vast majority are still waiting to hear back. In the meantime, the FSA sent out a second Dear CEO letter which according to the AFM showed that very little of the huge amount of information that had been presented to the FSA in that short period at the end of 2009 had actually been taken forward. So the new letter says: "We acknowledge that there is a much greater degree of diversity in the sector than we realised" but does little to demonstrate any appetite to deal with any of that and, in fact, presumes that its original position was still the right position for it to take."

Mutual insurers and with-profits

The FSA has decided that mutuals which are no longer writing significant volumes of with profits business should close these funds and distribute their value to with-profits policy holders.

This would have the effect in firms with a single capital fund of distributing of their entire capital, including that which had been accrued through other business operations, usually over many decades.

FSA has been downplaying the effects of its approach to with-profits in mutuals, indicating there will be little impact. Industry does not agree, and research amongst its members by the Association of Financial Mutuals in preparing its response to FSA's consultation paper on with-profits, reveals that 94% agreed with the statement: "we believe the implication is that the mutual with-profits sector will rapidly decline and within five to ten years the sector will have all but disappeared".

A Ministerial Statement of 1995 has provided clarity on distribution within proprietary insurers, which of course have separate categories of capital within their business. It was never intended to apply to mutuals, but has been used by FSA to defend their approach and to justify the transfer of capital to current policyholders that had previously been regarded as held in perpetuity for the benefit of present and future policyholders and members.

The FSA has based its view on a single piece of legal advice, compared to the various opinions obtained by the industry, the vast majority of which disagrees with the FSA 'general position'.

Whilst the FSA indicates that its hands are tied by Europe on many policy aspects, it has developed a definition of a mutual which contradicts European thinking; where the FSA considers membership has "little or no value", whilst a recent European

Commission research document has a very different approach when it states:

"The profits and surpluses of a mutual should not be used to pay a return on investment, but to improve the services offered to members, to finance and develop the insurance business for the benefit of members to increase its own reserves for the benefit of future generations."

The FSA should adopt this definition of a mutual immediately to reflect its commitment to mutuals.

The AFM reported that it is beginning to sense that it has reached an impasse with the FSA in terms of whether there is any capacity for them to re-open their original view. The AFM believes that there is a profound reluctance within the FSA to admit there were any errors in the regulatory process or even to conceive of the possibility that an alternative view was as valid as the FSA's own view.

"That impasse means that we are faced with a position where the mutual insurers will have to accept the FSA's position, which in many cases may involve having to pay out the capital held within the organisation to their policy holders over a fairly short period, and the consequence of that of course is that they will then have no working capital within the organisation and that means therefore that they will either shut up shop or they will demutualise."

The AFM's view was put very strongly to the FSA and also to Treasury in that it presents a significant and severe risk to the mutual insurance sector more generally and certainly makes it very difficult for their members to start to plan strategically whilst this uncertainty is hanging over them.

The Inquiry pursued this issue with the Chief Executive of the FSA. He was asked about the situation with the mutual life insurance sector and the fact that some may be forced to close or demutualise as a consequence of FSA policy.

Mr Sants did not accept the consequences,

"I do not think we would accept as given that the measures we are proposing would lead to the disappearance of the sector. Obviously, it does put some pressure on their ability to develop and grow new business lines, I accept that point, but I do not think it is in any way proven that this is going to lead to the disappearance of the sector as opposed to potentially some consolidation of the sector, which we are already seeing, but I come back to the point that consumer protection is a primary objective that you have given us to discharge."

The Inquiry also pressed the Government on this issue when the Minister gave evidence. Why for example, had HM Treasury remained silent in this matter, when it is responsible for mutuals policy?

Mark Hoban refused to be drawn into taking a HMT view as the FSA is an independent regulator:

"I think the FSA are in the process of preparing a consultation paper on this topic so I do not really wish to comment in advance of seeing that paper. I am aware of the concerns within the mutual insurer sector about the impact the FSA's proposals could have on them, but I think it is important to see that in the context of the consultation paper that is published."

Mr Hoban did confirm that the Government has had discussions with the FSA about this issue. He said, "We have had these discussions but it is not our policy to comment upon them. I can say we have had those conversations."

The Group recommends that:

- **Legislation establishing the new regulatory authorities must include 'Promoting mutuals and fostering diversity' within the statutory objectives.**
- **Moreover, Regulators should be statutorily committed to take account of diverse business structures.**
- **An overall Head of Mutuals policy should be appointed at the newly formed PRA.**
- **Whilst acknowledging recent improvements at the FSA, a person with similar experience to the Head**

of the Building Societies Directorate in the FSA should also be appointed to a mutuals insurance directorate in the new PRA to establish better links and understanding with mutual insurance companies and friendly societies.

- **Regulation needs to be proportionate, taking account of the relative risks posed by the business. Regulation should therefore be risk-based so as not to create a disproportionate burden on mutuals, large and small.**
- **The Government should intervene in the current impasse between mutual insurers and the FSA over capital issues. HM Treasury should first press the FSA to seek a second legal opinion on the issue of with profits capital funds. If it is not prepared to do so, Treasury should seek its own advice, in order to properly inform its policy responsibilities.**
- **The FSA consultation on capital in mutual insurance companies has now been completed so the Government should now make a statement on its own policy position in this matter.**

7.3 How can the Bank of England help to develop an approach that supports this policy objective?

The development of a new regulatory framework provides an opportunity to improve the regulatory relationship with the mutual sector and ensure that it is fit for purpose in delivering appropriate regulation, in line with government policy.

The Oxford University Report, which concluded that the Bank of England:

- Needs to have its accountability improved along with its increased powers.
- Should be required to explain what the impact of major policy decisions would be on mutuals and on the degree of diversity of the financial services sector
- Should also be required to report on diversity in the sector, producing an annual review of diversity (otherwise referred to as a Diversity Index) and how its actions have promoted it.

The new role for The Bank of England

The Inquiry asked the Industry's representatives if there was anything which requires improvement from their point of view that could be put to the Bank?

For the BSA, Mr Coles said:

"It is a bit too early to say that because we do not know how the PRA and FPC are going to operate. It is clear that the Bank of England will be a crucial organisation in the future. The Governor of the Bank of England, whoever he is and this is not a personal observation, is going to be Chairman of the Monetary Policy Committee, the Financial Policy Committee and the Prudential Regulatory Authority, with oversight also of the Consumer Protection and Markets Authority [now renamed the Financial Conduct Authority], so the Governor of the Bank is going to be a crucial figure in the future and it will be much more important in the way that building societies conduct their business than the Bank has been until recently. So it is of growing importance and it will get very much more important over the next couple of the years."

For the AFM, Mr Shaw added:

"At the moment the Bank of England is not directly involved in the regulation of insurance and therefore to become familiar with what we do that learning curve will be even steeper."

The Inquiry also wanted to find out from the Treasury if it believed there was a role for the Bank of England in helping mutuals and whether that was something that was under discussion.

Mr Hoban said:

"As part of the change in regulatory structure obviously the new prudential regulator will be in situ within the Bank of England and, as I touched on earlier on, in terms of the work that the PRA will do they will have to think about the impact of any proposals they make on the mutual sector. That is a specific requirement in legislation. I think that is quite an important advance on where we are at the moment. In that respect I think the PRA will take a much closer interest in the impact of regulatory changes on the whole sector for both mutual insurers and building societies as well of course."

On the point of diversity in the financial services sector, Mr Hoban described how the new regulatory regime would look and how this would affect mutuals. The PRA is responsible for the safety and soundness of mutual firms, the FCA is responsible for all aspects of financial conduct and the Financial Policy Committee's remit will cover system-wide financial stability.

Mr Hoban said,

"I think it is best to have a very clear focus about what these regulators do rather than confuse their mandates. We have been conscious of the representations from the mutual sector, which is why we have said that both for the FCA and the PRA as part of their cost benefit analysis they need to explicitly consider for the first time the statute and the impact of their reforms on the mutual sector."

The Inquiry heard that it is considered important by the mutual sector that the Bank should be required to explain decisions in relation to mutuals on each regulatory role and the Bank should also be required to report on diversity in the sector, producing an annual

review of diversity and how its actions have at least maintained and, if possible, increased it.

Measuring corporate diversity

The Group agrees that for the Government to achieve its aim of enhancing corporate diversity, it needs to measure the degree of diversity over time so that progress can be measured, and assurance can be given that the risks of a future credit crisis are indeed being reduced over time.

The Inquiry was keen to learn more about how a diversity index might work in practice and whether it needed to be government-owned. The possibility was raised of it being simply being government-endorsed and coming from across the whole of the financial services sector itself.

The BSA informed the Group that they are looking at commissioning academic research to define such a 'Diversity Index' and though they felt that it was not necessarily something the government would have to undertake itself, it would need government endorsement.

The question of the diversity index was raised when Hector Sants was asked if he thought that the FSA, or its successor, should have a role in devising and maintaining an index of corporate diversity in financial services.

Mr Sants was unaware of this recommendation of the Oxford Report,

"The question of whether we should have a diversity index is an interesting question, which has not been put to me before and I would like to reflect on it. We have also agreed that there are a number of high-level reasons why diversity of the business model within the financial system brings advantages to our objectives, so it is an interesting question as to whether we should be monitoring that as part of our current data collection and thorough analysis we should be doing, indeed are doing, so I will take it away as a thought to consider."

The BSA also wants to see under the new regulatory regime, with the FSA disappearing, the impact of new regulation on diversity carefully assessed. It felt that

the regulator often assumed,

"that the plc model is the norm with the mutual model as the deviant. We need to see mutuals and plcs regarded as equal but distinct and separate and each needing their own regulatory approach on things like capital (but not only capital)."

The Group recommends that:

- **A Government endorsed 'Diversity Index' should be established across the whole financial services sector.**
- **This measurement exercise should be undertaken at regular intervals, and the findings should be published in a timely manner.**
- **The Bank of England should be required to report on diversity in the financial services sector, producing an annual review of diversity and how its actions have at least maintained it and, if possible, increased it.**
- **The Bank of England should review its organisational structure to ensure that it reflects in a representative way the mix of firms for which it is now responsible.**

7.4 Is the legislative framework for financial mutuals adequate?

Legislation affecting mutuals sits in a number of sector specific Acts of Parliament, such as the Building Societies Act, Friendly Societies Act and Industrial & Provident Societies Act. In addition, many mutuals are registered under the Companies Act.

It is possible to trace the origins of much of this legislation to the 19th Century, with many principles established at that time remaining in force today. Of course, the legislation has been modernised many times since its inception, but the fractured nature of legal frameworks affecting mutuals has inevitably led to a time lag in updating law to keep pace with innovations in mainstream company legislation.

This was an opportunity to hear from the mutual sector if they felt any changes were needed around

the existing legislation that affects the mutuals they represent.

Before the 2010 general election, Mutuo published a 'Mutuals Manifesto,' which was widely welcomed by all political parties at the time. It contained a number of specific policy suggestions for the new Government to consider, including on legislation:

The Mutuals Manifesto 2010 :⁷

Ensure that mutual sector legislation keeps pace with company law reform

Real progress has been made in improving legislation affecting mutuals in recent years. In some cases, this has been long overdue and required significant effort to bring mutuals legislation into line with modernised legislation for companies.

Unlike legislation for conventional businesses, legislation affecting mutuals cuts across departments. It mostly resides with HM Treasury, but mutuals are businesses and BIS must have a shared role in developing this agenda. The current approach puts mutuals at a competitive disadvantage, where they often have to wait many years to enjoy the same benefits as companies.

Government should commit to continue this effort and ensure that going forward, co-operatives, building societies, friendly societies, employee owned firms and other mutuals are treated equally with companies in maintaining and improving their legislative environment.

Representatives of the mutual sector outlined examples of where legislative changes could be made to improve the operational effectiveness of mutuals.

One focus of the Mutuals Manifesto was to suggest that mutual sector legislation is regularly updated to ensure a level playing field with companies. This will

require HM Treasury, the department responsible for to operate a 'trigger' procedure for updating mutuals legislation when company law changes are considered. This will necessitate close collaboration with the Department for Business, Innovation and Skills which is responsible for company law.

In its evidence to the Inquiry, the Building Societies Association stated that as far as building society legislation is concerned there are mundane but important issues such as the updating of Section 9 of the Act which would give building societies a little more freedom in relation to transacting business with companies.

These provisions enable building societies to take advantage of the most recent improvements in personal IT, for example, where legislation does not facilitate societies doing that as well as companies can. There are also issues relating to the use of the SLS where a technicality makes it more difficult for building societies than banks to enter into re-purchase arrangements with the Bank of England, which affects how the markets operate.

There are also issues relating to the Mutuals Societies Transfers arrangements (known in the sector as the Butterfill legislation) and the extent to which different types of mutuals can merge with one another.

The BSA welcomed the merger of the Britannia Building Society with Co-operative Financial Services but pointed out that at the moment the legislation is not in place to enable a friendly society and a building society to merge, for example, and that might be sensible as envisaged by the Butterfill Act.

Mr Shaw for the AFM also felt that his sector's needs revolved around bringing the legislation up-to-date. He gave the example of electronic communications, noting that whilst building societies have an Order which allows them to do some kind of electronic communication, friendly societies are unable as yet to communicate electronically with their members, even though this was first permitted for companies in 2000 through the Companies Act.

The Group sees that there is a clear need to urgently update such provisions that will improve the operational effectiveness of the sector.

The Group heard of the effect that the cancelling of Government support for the Child Trust Fund has had on mutual insurers and friendly societies.

Mr Shaw:

“Over the last 12 months, two particular issues have now come to bear on us. One of them is the demise of the Child Trust Fund. 12 of my members were very heavily committed to that product and between them have well over 50 per cent of all Child Trust Funds and every one of those is now having to review its forward strategy very carefully. We are therefore working with the Treasury around new solutions, but it is by no means certain what those will look like and whether or not they will enable the mutual insurance sector to be a natural home for the future.”

He also talked about the restrictive nature of friendly society legislation,

“We are significant investors in the UK. We have around £80 billion in assets across the mutual insurance sector. We are largely constrained as to what we can do with that money. We have to invest it into equities, property or gilts, so we do not have the capacity to lend that money out in the way that building societies do. That means that at certain times in the economic cycle none of those particular investments is that attractive and all of them tend to rise and fall more or less in unison, so we have been talking to the Treasury about how there may be other options for us to invest in longer term vehicles which might therefore also help government with some of the issues that it is trying to grapple with, such as where you fill the void in infrastructure investments if the government no longer has the money to invest in those kinds of things.”

The Government’s response was underlined by Mark Hoban MP when he stated:

“I think in respect to mutual insurers they need to come forward with their own proposals for change. The building society sector has been very proactive in identifying issues that need to be resolved and where we are able

to do so we have sought to do that. I do think there is an onus on the sector to come forward with concrete proposals and we will listen to them in the same way we listen to those from the credit union sector and also from building societies.”

Since the last evidence session, the Treasury Consultation on the new regulatory regime will require the PRA and FCA to include consideration of any different impact of proposed rules on mutuals. This is an important and welcome concession though it will only work if the regulators take the issue seriously and review thoroughly the case-benefit implications.

The Group recommends that:

- **HM Treasury should operate a formal ‘trigger’ process to ensure that legislation for financial mutuals keeps pace with where appropriate, and is given the same priority as, company law reform.**
- **Legislation should be brought forward to enable all types of mutuals to merge, as envisaged under the ‘Butterfill Act.’**
- **HM Treasury should work with the mutual insurance sector to agree legislative changes that will enable them to invest more flexibly in the public interest.**

7.5 In what other ways could the Government engage with mutual businesses to improve the corporate diversity of financial services providers?

The focus of this part of the Inquiry was to examine the interface between Government and the financial mutual sector, and to explore other practical opportunities for promoting mutuals.

Clearly, witnesses from the mutual sector had reported what they described as a lack of sufficient thought from HM Treasury and the Financial Services Authority in their dealings with mutuals.

As a Group, we can conclude that this appears to be caused, at least in part, by a lack of clarity and status being given to matters affecting mutuals. Although

the Financial Secretary is responsible for dealing with mutuals on a regular basis, this is in addition to his many other responsibilities.

The Group wondered if there is a need for a specific Minister to take responsibility in Government, and suitably senior named officials in the FSA.

The Mutuals Manifesto called for a Minister for Mutuals - based in the Treasury and similar in status to the Minister for the City - and would be able to deal across the various government departments that have to deal with the mutual sector.

"The Minister could be supported by a team of Officials who would work together as the 'Government Office for Mutuals'. The Officials could be drawn from existing HM Treasury/BIS functions."

Mr Coles for the BSA supported this suggestion and added that,

"Within the PRA and the FCA there should be a head of mutuals policy, not just a head of supervision, whose role it is to examine the impacts of those two bodies' regulatory proposals on mutuals specifically."

This is discussed in more detail in previous sections.

Competition and diversity

More broadly, the BSA was also concerned about the effect that Government bail-outs have had on competition in the mortgage and savings market, where those institutions that have failed have received significant taxpayer support and have now become more dominant in the market.

Mr Coles said:

"Those institutions that stood on their own two feet, which is the bulk of the mutuals sector, and did not need taxpayer support are now suffering significantly as a result of the changes made over the last two or three years, and that is a huge issue that we need to resolve."

The remutualisation of Northern Rock

The banking crisis highlighted the importance to the UK economy of retaining diverse models of financial

service providers. Mutuals, though affected by the downturn, have been more stable than proprietary banks.

Given the difficulties of setting up a new mutual of any size in the deposit-taking sphere, it makes sense to explore the re-mutualising of a mature ex-mutual business, as well as conserving remaining mutuals.

Clearly, the disposal of Government owned banks is key to ensuring a stable and competitively diverse financial services sector. It presents Government with an almost unique opportunity to influence the future direction of the industry towards more stable providers.

In 2009, the Oxford Centre for Mutuals and Employee Owned Business published a report considering the possibility of remutualising Northern Rock. The Inquiry was keen to look at the position concerning Northern Rock and what arrangements might be made for the future ownership of Northern Rock. A considerable number of Members of Parliament have signed an Early Day Motion (EDM 1351, tabled in January 2011) calling for UKFI to explore the option of remutualisation of Northern Rock. The Group wanted to discover the Government's current position on this.

Northern Rock, an ex-mutual, remains a relatively straightforward and mature savings and mortgage business. As such, it is particularly suitable for resumption of mutual ownership.

The Centre for Mutual and Employee-owned Business at Oxford University produced a report that considered the remutualisation of Northern Rock. The report anticipated that the Government and the UK economy would benefit significantly from transferring the Northern Rock business to a new mutual society.

Such a transaction would:

- Create a stable financial services provider, constrained from repeating its previous mistakes.
- Be achieved at relatively little net cost to HM Treasury, and may even give a superior return in the long run.

- Counter the further concentration and loss of competition likely to result from a trade sale.
- Avoid the political risk of selling the holdings into a depressed market, and appearing to lose value for the taxpayer.
- Make a strong statement that the Government intends to support responsible financial institutions.
- Support the promotion of diversity in financial institutions.
- Secure the future value of the business for the public benefit.

Under such a remutualisation, the Government's senior debt and any other funding holdings could be repaid over time under any ownership scenario, therefore the main financial issue is realising the equity value of Northern Rock for the taxpayer. It is unclear how much this value is, but an early trade sale, at today's prices and with a reported £200 million discount, may prove a poor bargain.

A new mutual could either repay the value of this equity to the Government in cash over a fixed period, or offer a reliable perpetual income stream whose net present value could match or even exceed the current equity value.

The new instrument recently introduced in the building society sector - profit participating deferred shares or PPDS - illustrates how capital can be provided in a way that carries modest servicing costs to begin with but can deliver a fair overall return in the long term. This overcomes one of the fundamental problems of either setting up a new mutual or mutualising an existing business: how to raise the necessary capital when to begin with the business cannot afford to pay a high return on the investment.

Other institutional investors could be considered, through a range of capital instruments, as part of the wider mutual.

The new mutual could be either a building society - which would have the crucial advantage of limiting to 50% the proportion of funds the new mutual could

raise from the wholesale markets, thus eliminating any chance of the new Northern Rock repeating the mistake of its plc predecessor - or another type of financial mutual.

Crucially, the new mutual should have an asset lock that ensured members only benefited from their ongoing financial relationship with the business. They would have no right to the underlying assets of the mutuals as these would, in effect, be held 'in trust' for the use of future members or for the wider public benefit.

This asset lock could be achieved under existing legislation/charitable assignment practices common in other mutuals. The new mutual would be managed by an Executive team with support from newly recruited non-executive directors.

There are several options for how membership could be offered; it could be held by existing and new customers of Northern Rock, and would accrue benefits as long as the members trade with the mutual. Crucially, it would be clear up front that it did not confer an individual proprietary stake in the business: and the underlying assets could not be demutualised. So members would have no incentive other than to see the business stick to its core activities.

The Oxford University Report of 2010 again supported this option "Keeping a reformed Northern Rock independent of the big banks will be good for competition. Northern Rock could be converted to an asset-locked public interest mutual. As a mutual committed to its core business, a remutualised Northern Rock would help the Government by supporting competition and diversity through the maintenance of a strong mutually-owned financial sector.

In any exit process the Government needs to realise the optimum value for the taxpayer. A re-launched and re-mutualised Northern Rock can repay the taxpayer stake over time. A deferred payment profile can give the optimum outcome, both returning the full value to the taxpayer but also achieving other public policy goals."

The EDM was followed up by debates held in the House of Commons and House of Lords around the issue in February and March of this year. The first was held by Gareth Thomas MP when he called on the Government in his Westminster Hall Debate on the Future of Financial Mutuals to carry out a full feasibility study examining in detail the financial, governance and leadership issues in respect of a remutualisation of Northern Rock.

These debates led to the Government response that UKFI, which manages the Government's investments and financial institutions and is responsible for devising appropriate exit strategies is currently exploring the options available for disposing of Northern Rock plc. They confirmed that, "All exit strategies will be considered, including remutualisation."

Subsequently, Gareth Thomas asked the following Question at Prime Minister's Questions on 16 March: "I draw the attention of the House to the interest that I have previously declared. There are very few people outside the House-or, I suspect, inside it-who think that Northern Rock would have got into as much trouble if it had still been a mutual building society. Given the considerable scepticism about whether the coalition really wants to change the culture in the banking industry, will the Prime Minister now insist that his City Minister requests a serious and detailed assessment of the case for remutualisation of Northern Rock?"

The Prime Minister, David Cameron replied:

"We are prepared to consider all options, and the City Minister will do that. I would make two points. First, we think that mutualisation should go much further than just the banking industry, and are considering options for mutualisation within the public sector to give members of staff in public sector organisations far more control over the organisations that they are in. On banking, it is about looking at not just mutualisation but the whole issue of responsibility and trying to link in again the idea of taking deposits and making loans, as building societies used to."

During the Short inquiry, Mr Hoban confirmed that UKFI, which is responsible for managing the Government's holdings in Northern Rock, RBS and Lloyds, have

appointed a financial adviser to look at the future of Northern Rock and the Government has discussed with UKFI the need to consider the option of remutualisation as part of that.

He stated,

"It is very much on the table and I understand from press reports that at least two building societies have expressed an interest in Northern Rock...I am open-minded. All I would say is that UKFI, Northern Rock and their financial adviser will need to look at any plans that are put forward. They will need to be robust. They will need to meet the Government's wider objectives around the management of the estates."

The Group believes that the Government is faced with clear choices, and notes with disappointment the Chancellor's Mansion House speech, in which he stated the Government's aim to sell Northern Rock. Ultimately, this may be the right decision, but it can only be made once the option of re-mutualising Northern Rock has been fully evaluated. This has clearly not yet happened.

The Group recommends that:

- **There should be a dedicated Government Minister for Mutuals in HM Treasury - similar in status to the Minister for the City who would be able to deal across the various government departments that have to deal with the mutual sector. The Minister for Mutuals should also have a mandate that encourages the sharing of ideas across government departments.**
- **The Treasury should ensure that its actions to stabilise the financial system do not inadvertently skew competition in the market and provide advantages to failed financial services businesses in public ownership.**
- **The Government should fully consider remutualising Northern Rock, and publish the advice that it has received in this matter.**

8 Names and Dates of Witnesses Examined

First examination of witnesses: Monday 22nd November 2010

Mr Adrian Coles OBE, Director General, Building Societies Association

Mr Martin Shaw, Chief Executive, Association of Financial Mutuals

Second Examination of Witnesses: Thursday 27th January 2011

Mr Hector Sants, Chief Executive, Financial Services Authority

Mr Martin Stewart, Head of Building Societies, Financial Services Authority

Third Examination of Witnesses: Wednesday 11th May 2011

Mr Mark Hoban MP, Financial Secretary, HM Treasury

9 Evidence submitted

Association of British Credit Unions Limited (ABCUL) submission to the Inquiry

The Children's Mutual submission to the Inquiry

Forester Life's submission to the Inquiry

Professor Jonathan Michie, Mutual and Employee-Owned Business Centre, Kellogg College, Oxford University - publications submitted to the Inquiry

Mutuo publications submitted to the Inquiry

Glossary

APPG	All-Party Parliamentary Group
BSA	Building Societies Association
AFM	Association of Financial Mutuals
FSA	Financial Services Authority



The All-Party Parliamentary Group
for Building Societies & Financial Mutuals