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Mutuals Deferred Shares Bill

Bill No 145 [HL] of 2014/15

RESEARCH PAPER 14/68 29 December 2014

This Bill is a government-supported Private Members' Bill which started in the Lords. The Member sponsoring the Bill in the Commons is Johnathan Evans. It would enable mutual insurance companies, some of which are amongst the oldest continuous companies in the country, to raise capital in new ways. The financial crisis exposed the need for financial institutions to have greater financial reserves and this has proved difficult for mutual organisations which cannot issue share capital. The Bill applies to the whole of the UK.

Timothy Edmonds

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Research Paper 14/68

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Contents

Summary

Ever since the financial crash of 2008 financial institutions have been forced to look at ways of making themselves more robust in the face of possible future crises. Banks and other 'systemic' firms have undertaken successive rounds of capital raising, mostly by issuing shares. For the mutual sector however, raising capital has been more of a challenge and regulators, the industry and governments have sought answers to the question of how such institutions, for example building societies, can raise capital whilst retaining their mutual status.

This Bill is the answer to this broader question for a fairly narrow base of institutions – mutual insurers and Friendly Societies. It is a Private Members' Bill introduced in the Lords but which has government support and assistance. There is a history of such Bills being used to introduce legislation favourable to the mutual sector.

The Bill would permit mutuals to issue deferred shares. Holders would have restricted voting rights and repayment of capital could be limited to the nominal value of the share instrument.

The Bill has broad all-party support, government assistance and backing from the industry trade body which has contributed to its content. It passed through its Lords stages with little debate.

1 Introduction

1.1 The problem

Ever since the financial crash of 2008 financial institutions have been forced, by regulators, to look at ways of making themselves more robust in the face of possible future crises. Banks and other 'systemic' firms have undertaken successive rounds of capital raising, mostly by issuing shares. For the mutual sector however, raising capital has been more of a challenge and regulators, the industry and governments have sought answers to the question of how such institutions, for example building societies (to whom this Bill does not apply), can raise capital whilst retaining their mutual status.

For the regulators the 'holy grail' is permanent, high quality capital which can bear losses. The regulatory challenge for the mutual organisations is that several key aspects of their constitutions and the behaviour of their members work against each other. By definition mutuals are owned by their members. They do not have an option to issue free-standing shares on the open stock market. Their capital is essentially profits plus certain equity investments. But, such a base can be difficult to expand quickly or on a large scale.

Mutuals have the difficulty of somehow finding high quality capital consistent with their status and a lot of work has been undertaken by industry and regulators to find new forms of financial instrument that would work for both sides.

This Bill attempts to provide a solution for two sectors: mutual insurers and the Friendly Societies.

1.2 The institutions

Today, the 'friendlies' and the mutual insurers are represented by the Association of Financial Mutuals, which is composed of 52 member companies which "collectively look after the savings, protection and healthcare of 20 million customers and manage assets of £100 billion."[1]

Of the Membership, the best known might be *Equitable Life* and the *Ancient Order of Foresters*. Others are less familiar but have wonderful sounding names that reach back into the industrial past, for example, the oldest of all is the '*Grand United Order of Oddfellows'*, or the charmingly named '*Shepherds Friendly Society*' which "started life as a sickness and benefits society and were an amalgamation of various fraternal groups - The Royal Shepherds Sanctuary Benefit Society which was established in Yorkshire in the early 19th century, Ashton Unity which was formed in 1826 and the Ancient Order of Shepherds" (see below).

[1] Association of Financial Mutuals website [accessed 24 December 2014]

There have been a number of pieces of legislation over the past ten years to streamline and modernise the whole cooperative and mutual financial and legal framework, for example the *Co-operative & Community Benefit Society and Credit Unions Act 2003* and the *Building Societies Funding and Mutual Societies (Transfers) Act 2007.*[2] All parties are in favour of a successful 'alternative' financial sector and the financial crash gave added intellectual backing for greater diversity within the market place.

The aim of much of the legislation is to allow the traditional institutions to develop in scale. The unfortunate example of the Co-operative Bank, whose troubles date back to the legislatively enabled take-over of the Britannia Building Society, emphasises how difficult is the process of organisations changing their scale or what they do. The fact that "half of the UK insurance market was mutual in 1995, but since then, in fewer than 20 years, it has shrunk to 7.5%"[3], illustrates the peril of not doing so.

2 The Bill

2.1 Lords' Proceedings

The Bill was introduced into the Lords on 24 October 2014 by the Conservative Peer Lord Naseby under its original title of the *Mutuals Redeemable and Deferred Shares Bill [HL Bill 5]*. He outlined the two year 'gestation' of the Bill and the considerable government support it had already received. He continued:

> The Bill refers to two classes of shares—deferred shares and redeemable shares. One of the key hurdles that I and my team have had to jump was to persuade the regulator that both those vehicles meet the requirements of Solvency II and would therefore be eligible for tier 1 capital, which is absolutely vital for development capital. We have been successful with the deferred shares element, but have not yet persuaded all parties that it is possible for redeemable shares as well. I therefore had to make a decision on whether to go ahead now with just the deferred element of the Bill, which goes a long way to help mutual insurers and friendly societies, or whether to persevere to try to persuade the authorities about redeemable shares. I decided, in the face of having only five months left of this Parliament, to drop the redeemable element. I suspect that my noble friend on the Front Bench will do just that in Committee, in moving certain government amendments.[4]

The Bill would allow mutuals to issue a new class of *deferred* share. Holders of such shares would be members of the society, but would only have one vote irrespective of their shareholding, and they might only receive the value of their investment if the society was wound up. Regulations would set out the details of how such shares might be issued. It is anticipated that such instruments would qualify as capital under the Solvency II Directive (the insurance 'equivalent' of the Basel capital requirements).[5] Lord Naseby set out the main arguments in favour of his Bill as follows:

> It is important because it gives access to new capital, particularly for friendly societies and mutual insurers. First, all mutuals need to be able to play a full part in our economy with diverse corporate ownership. Friendly societies and mutual insurers do not have the ability to raise capital that some co-operatives and building societies do, or indeed public limited companies.

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2 Previously known as the *Financial Mutuals Arrangements Bill*
3 HL Deb 24 October 2014, c921
4 HL Deb 24 October 2014 c918
5 More information on Solvency II can be found in Library Standard Note 6339

> Secondly, without new capital, many mutuals could be driven into inappropriate corporate forms through demutualisation. If more mutuals convert to other corporate forms, consumer choice would be reduced and large numbers of consumers would no longer have non-listed, member-owned options in the financial services marketplace. This both reduces competitive pressure from the operation of different business models in the same market and adds to systemic risk to the economy.
>
> Thirdly, a lack of capital limits mutuals' growth and the ability to develop new services. The growth rate of a mutual is constrained by its relative inability to add capital through retained earnings.
>
> Fourthly, like all businesses, mutuals need to be able to benefit from the economies of scale available only by growing their business. Mutuals need to gather sufficient capital to serve their members well, extend services to new members, expand their menu of services and achieve economies of scale.
>
> Fifthly, it is important to learn the lessons from the recent financial crisis. If financial services businesses are to build up stronger capital bases, they require the legislative and regulatory agility with which to do so.
>
> Sixthly, there are direct benefits of being able to issue these new shares. Debt, the alternative, is of a lower quality than equity for firms wishing to build their capital base. There is inevitably a limit to the amount of debt that can or should be raised. Mutual shares would therefore present an opportunity for small mutuals to raise funds that they may not be able to do otherwise, and for larger mutuals to raise tier 1 funds that subordinated debt does not provide.[6]

In its original form the Bill would also have allowed co-operative and community benefit societies to issue redeemable shares for similar reasons as for the deferred shares. The Government were 'unpersuaded' about this part of the Bill and these clauses were deleted.[7] The Government spokesman in the Lords, Lord Newby said:

> In respect of the proposed redeemable share instrument for co-operative and community benefit societies, the Government are unpersuaded about the merit of a redeemable share instrument as these societies already have a means of issuing redeemable shares. The Government do not see a clear need and demand for such an instrument, and as we have heard, in discussion with and the agreement of the noble Lord, Lord Naseby, we propose to bring forward amendments in Committee to delete these elements.[8]

The Bill was heavily amended by the Government in a short Committee stage. New provisions concerning the powers of future Regulations were agreed to; the restriction on voting rights was redrawn and the provisions concerning redeemable shares were deleted.[9] The Government also made consequential amendments and several drafting amendments. The amendments were agreed to by the Bill's promoter Lord Naseby. The remaining stages were purely formal.

2.2 Current state

Bill 145 was introduced on the 17 December 2014. It has two substantive clauses; together these clauses allow for a new share type to be issued but also retain the mutual characteristics of the institution:

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6 HL Deb 24 October 2014 c919

7 HL Deb 21 November 2014 c615

8 HL Deb 24 October 2014 c922

9 PBC 21 November 2014 c 612

Clause 1 Power to permit or facilitate the issue of deferred shares

(1) The Treasury may by regulations make provision to permit or facilitate the issue of deferred shares by a friendly society or mutual insurer.

(2) “Deferred shares” are instruments that—

(a) are issued by a friendly society or mutual insurer (“the issuer”) with the consent of the appropriate authority,

(b) can be transferred but not withdrawn,

(c) prohibit repayment of principal other than—

(i) on the winding up or dissolution of the issuer where all other sums due from the issuer to creditors claiming in the winding up or dissolution are paid in full, or

(ii) where the appropriate authority has consented to the repayment, and

(d) have such characteristics as are specified in regulations made by the Treasury under this paragraph.

(3) Regulations under subsection (1) may modify any of the following—

(a) the Friendly Societies Act 1992 (as amended from time to time);

(b) the Companies Act 2006 (as amended from time to time);

(c) any other primary legislation relating to friendly societies or mutual insurers (whenever passed);

(d) any instrument made under the legislation mentioned in any of paragraphs (a) to (c) (whenever made).

(4) Regulations under subsection (1)—

(a) may not make provision that would permit or facilitate the issue of deferred shares by a friendly society or mutual insurer where it is not authorised to do so by its memorandum, rules or constitution;

(b) may make consequential, supplementary, incidental, transitional or saving provision;

(c) may make different provision for different purposes.

(5) A deferred share issued by virtue of regulations made under subsection (1) is not a share within the meaning of the Companies Acts.

(6) The power to make regulations under this section is exercisable by statutory instrument.

(7) A statutory instrument containing regulations under this section may not be made unless a draft of it has been laid before and approved by a resolution of each House of Parliament.

Clause 2 Restriction on voting rights

> (1) Regulations under section 1(1) must make provision to ensure that no friendly society or mutual insurer will confer—
>
> > (a) more than one vote per person as a member on holders of deferred shares who are members of the society or insurer by virtue only of being such a holder;
> >
> > (b) additional voting rights on a member of the society or insurer by virtue of being a holder of a deferred share where the member is a member other than by virtue of being such a holder.
>
> (2) Regulations under section 1(1) must make provision prohibiting the holder of
>
> a deferred share who is a member of a friendly society or mutual insurer by virtue only of being such a holder from proposing or voting in respect of any of the following—
>
> > (a) a resolution under section 85, 86 or 91 of the Friendly Societies Act 1992 (amalgamation, transfer of engagements or conversions);
> >
> > (b) a resolution to similar effect in the case of a mutual insurer, including a compromise or arrangement proposed at a meeting called under section 896 of the Companies Act 2006 (court order for holding meeting);
> >
> > (c) an arrangement made in pursuance of section 110 of the Insolvency Act 1986 (acceptance of shares etc as consideration for sale of company property) or Article 96 of the Insolvency (Northern Ireland) Order 1989 (S.I. 1989 / 2405 (N.I. 19));
> >
> > (d) such other matters as the regulations may specify.
>
> (3) References in this section to the holder of a deferred share are to the holder of a deferred share issued by virtue of regulations made under section 1(1).

Further information on the progress of the Bill can be found on the Parliament Bill pages here.

Comment

The Association of Financial Mutuals (AFM) produced a response to the Bill when it was first published. In a covering press release the Chief Executive of AFM, Martin Shaw, said:

> We wholeheartedly support the Bill, and the welcome opportunity it would bring for mutual insurers and friendly societies – it can only be good for healthy competition in financial services. Being able to raise new forms of capital will help mutuals to deliver their business strategy more effectively, to adapt better to new market conditions, and to grow through acquisition.
>
> It is still early in the process, but we might expect this form of capital raising to include retail bonds, which could prove attractive to some consumers. The main reason we are keen to support this work would be to look for longer term strategic opportunities for the sector since it is already well-placed and on track to meet current capital requirements.

AFM further remarked that this was "a complex process and the legislation will take some time to complete, and AFM is pleased to be actively supporting this work".[10]

[10] AFM website

Concurrent with the Bill's publication the AFM also produced a *Manifesto for Financial Mutuals* in November 2014. A supporting press release outlines the key points and its motivation:

> 'A Manifesto for Financial Mutuals', aims to level the playing field between shareholder controlled plcs and mutually owned providers. It calls for:
>
> • A fair deal for consumers
>
> • A level playing field for financial mutual
>
> • A rational approach by regulators to capital
>
> • A more coordinated approach to promoting mutuals, creating a stronger savings culture and tackling the housing crisis
>
> Robin Fieth, Chief Executive of the BSA commented:
>
> *"There is a widespread consensus that a diverse financial sector benefits consumers and the economy alike. Therefore, it is a bitter irony that in the effort to address poor behaviour by some plcs and prevent another financial crisis, the resulting legislative and regulatory framework threatens to undermine rather than support corporate diversity.*
>
> *"Ratcheting up regulation across the board is leading to a matrix of rigid rules that disproportionately affects mutuals. Instead, the differences inherent in the mutual structure should be considered side by side with other types of financial services businesses. Today we are setting out a plan to redress the balance and strengthen the mutual sector."*
>
> Martin Shaw, Chief Executive of the AFM added:
>
> *"Consumers are being left with little choice but to go back to the very firms that caused the last recession in the first place. Far from fostering diversity and ensuring the financial sector is more resilient, the present regulatory landscape is tilted towards a one size fits all model.*
>
> *"It should be a national scandal that not a single new mutual has been set up since the last decade of the last century. Politicians need to translate their aspirations for greater diversity into concrete actions to help the financial mutuals sector to compete on level terms, and to deliver a fairer marketplace for consumers."*

In response to a Treasury consultation about implementation of Solvency II the AFM said "We agree with the overall proposals in the consultation".[11]

[11] AFM website