

Response to the Treasury Consultation on Mutual Deferred Shares

Introduction

OAC welcomes the opportunity to comment on this Consultation Paper. OAC is a provider of actuarial and other consultancy services and has a significant number of Friendly Societies as its clients.

Comments

OAC welcomes the publication of the consultation paper and draft regulations and looks forward to the opportunities that Mutual Deferred Shares ("MDS") will create to raise capital to support the expansion of mutual insurers' businesses.

We believe that the proposals in the paper are a useful starting point however we also consider that there are a number of issues which need to be resolved before mutual firms are able to take advantage of the ability to raise capital under the new legal framework.

We believe that the most significant issues which need resolution are the potential tax treatment of mutuals which have raised capital in this way and the requirement for a mutual to formally undertake a segregation of funds before making an issue of Mutual Deferred Shares. We are also very concerned about the potential costs which we believe have been underestimated.

Consultation Questions

Our responses to the specific questions are:

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

We understand the proposal that MDS should either have the features of restricted or unrestricted Tier 1 own funds. However, this is not a requirement of the Act and potentially limits the purposes for which MDS can be used as not all issuers will need MDS to meet Solvency II capital requirements. To impose the Solvency II restrictions on shares which are not issued to raise tier 1 own funds will make them less attractive to potential investors and more expensive for the mutual to issue.

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

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

As we said in our opening remarks we are concerned about the impact of Regulation 4(2)(a)-(c) which deals with the segregation of members' and policyholders' funds, the "Project Chrysalis" issue.

Project Chrysalis is relevant only to with-profits mutuals. Not all issuers of MDS will necessarily be with-profits mutuals and it does not seem appropriate to impose a condition of this nature upon them.

Even for firms which are with-profits a segregation of funds, as provided for in COBS20 is not the only approach. To require firms to go through this process imposes a further layer of difficulty and cost on the process of issuing MDS.

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

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

However we do not believe there is any corresponding definition applicable to Friendly Societies, and it may be appropriate to modify the 1992 Act to allow for such a definition.

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

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

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

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

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

We agree with the criteria for regulatory consent however we feel the need to point out that our recent experience has been that the FCA can take months to consider even a relatively simple transaction and it may be that there should be a limit on the amount of time the regulator should have to consider the proposal.

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

We note that the reference to one-member-one-vote does not take account of the delegate voting system retained by a number of friendly societies. This implies that unless shareholder members are able to vote on a one-member-one-vote basis, the society would be unable to issue MDS. Therefore a society with a delegate based voting system would need to ask its members to accept significant constitutional change in order to issue MDS.

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

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

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

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

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

We believe that the costs of issue could be very significant. If a with-profits mutual is required to go through a segregation of funds exercise prior to an application to issue MDS, the cost of that exercise alone could be £1.0m. Once that process has been accomplished then a mutual must go through all the process of consulting its members and changing its constitution. It should be realized that every mailing is likely to cost £1 per member. The costs of legal and actuarial support for the proposal are likely to be high, apart from the cost of internal management time spent on the process.

This is before the actual costs of issuing the shares which, as they are to be traded on a regulated market, could also be in excess of £1m. We would suggest that the total cost of the process is likely to be several million pounds which will be a huge disincentive to all but the largest firms.

For with-profits firms a particular difficulty arises with COBS 20.2.39 which requires that "A [firm](#) must not enter into a material transaction relating to a [with-profits fund](#) unless, in the reasonable opinion of the [firm's governing body](#), the transaction is unlikely to have a material adverse effect on the interests of that fund's existing [with-profits policyholders](#)." Demonstrating that expenditure of this magnitude will not adversely affect with-profits policyholders will be a very high hurdle for firms to jump.

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

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

An issuer will need certainty that a proposed issue of MDS will not trigger the loss of its exemption from corporation tax; otherwise no mutual board will risk proceeding with an issue. Certainty can be provided by legislating to provide a clear cut-off point below which mutuals will know with certainty that the issue of MDS will not jeopardise their tax status. For friendly societies further clarity can be provided by modifying Part II of the Friendly Societies Act to make clear that the issue of MDS is one of the powers of an incorporated society and not one of its purposes.

We hope this response is helpful.

Yours faithfully



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