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RESTRICTIONS ON THE RETAIL DISTRIBUTION OF REGULATORY CAPITAL INSTRUMENTS – FCA CP 14/23

RESPONSE FROM THE BUILDING SOCIETIES ASSOCIATION

Summary

The Building Societies Association (BSA) is pleased to respond to the FCA's consultation, particularly the proposals regarding mutual shares, to which we gave a qualified welcome when they were published on 27 November. We do not object to the proposal to restrict the retail distribution of CoCos, and we are broadly content with the new approach the FCA proposes for mutual shares, such as Core Capital Deferred Shares (CCDS). We think the CP still somewhat overstates the relative risks to investors from mutual shares, but no society would want to see CCDS bought by retail savers under any misapprehension as to the nature of the instrument, or by investors who over-commit their investable wealth. We suggest below a couple of improvements to the rules for mutual shares.

The proposed regime for mutual shares broadly parallels that already introduced for crowd funding. CCDS, which would typically be issued to raise capital for expansion by a well-established society, are undoubtedly less risky in general than crowd funding investments, which raise capital for a wide range of purposes, including in particular for unproven start-ups. While we differ from the FCA on the assessment of relative risk, nevertheless the building society sector can operate restrictions of the same or greater rigor. Societies are motivated to go the extra mile in observing the highest standards in order to protect both their own members and themselves.

Unless FCA can undertake to complete the rule making process quickly (in view of the delay, already experienced, of 15 months from the time that the CP was originally promised), the continuation of so-called "voluntary" agreement of case-by-case minimum denominations is not appropriate– societies that wish to issue CCDS should be able, if necessary, to early adopt the draft rules instead. (CoCo issuers already have that advantage, as they can comply with the temporary CoCo rules in the TPIR instead.)

Distribution of CoCos (QQ 1-7 refer)

We agree that certain features of CoCos, particularly those connected with the operation of the high-level trigger, are complex and difficult for ordinary retail investors to understand. While we would not necessarily agree with the FCA's assessment of, and reaction to, each of the risks mentioned in paragraph 2.11, we do not object to the overall conclusion that the distribution of CoCos should be restricted to high net worth or sophisticated retail clients alongside professional and institutional clients. We also agree that there is a comparable risk from non-EEA CoCos and equivalent securities issued by insurers.

We agree that records should be kept to evidence the appropriate promotion, suitability, and sale of CoCos, and such records will in fact protect the issuing firm from false claims subsequently made by disgruntled investors. We do not think it is sensible, or proportionate, for the compliance department to check the compliance of every single sale – instead, there should be robust systems to deliver compliance, and these should be tested, say by checking a sample. Annual review of the approval process is appropriate where there is ongoing issuance, but where a firm has made one CoCo issue and then no further issues for several years, an annual review is superfluous – more important for the approval process to be reviewed prior to any further issue if more than a year has elapsed since the last review.

We do not object to the restrictions being extended to pooled investment in CoCos, though again we think the FCA may have overstated the relative risks.

Distribution of mutual shares

CoCos and CCDS are quite different: CCDS do not have the complexity of the high level trigger, and their ultimate risk is the same as with PLC bank ordinary shares – both provide CET 1 capital, and the investor risks both first loss and total loss. The similarity of the ultimate risk is underlined following the implementation of the EU Bank Recovery and Resolution Directive from 1 January: both PLC bank ordinary shares, and CCDS, will be the first in line to be subject to mandatory write-down at the point of non-viability. Not only is it essential for mutual societies not to be disadvantaged in access to capital by applying the same restrictions as for CoCos, but there is no case to do so : the approach the FCA proposes for mutual shares (based, as we have pointed out, on the much riskier model of crowd-funding) provides entirely adequate consumer protection. We agree with the FCA's conclusion that the main risk of potentially inappropriate sales to a less sophisticated client base is in the primary market. Building societies do not consider their branch networks to be an appropriate distribution channel for CCDS, nor do the BSA. No specific restrictions are needed, however, for secondary sales, which may anyway be infrequent. So our replies to the key questions are ;

Q8 – **No.** CCDS should be capable of wider retail distribution.

Q9 – **Not necessarily**

Q10 - **No**

We agree that CCDS should be capable of being issued, subject to the proposed safeguards, to retail investors who are not high net worth or sophisticated. The principal safeguards - a specific risk warning that the client must sign to acknowledge, and an undertaking to limit investment to a small percentage of net investable wealth, provide the additional consumer protection that is needed.

We therefore agree with the FCA's conclusion regarding mutual shares in paragraph 3.21 :

"We expect that the effect of the proposals would be that consumers who decide to invest in these securities would have at least a basic awareness of the risks involved, and would only invest money they could afford to lose."

However, we consider that the percentage should be set at 10% - the same as for crowdfunding, not 5% as the FCA proposes (in line with its tendency to overstate the risks of CCDS relative to crowdfunding). We do not agree with the FCA's assertion that crowdfunding investors tend to be relatively experienced and pro-actively search out these investment opportunities via platforms. This may have been true five years ago when crowdfunding began, but several recent notable instances - indicative of the direction of travel – tend to disprove the FCA's hypothesis.

Since the FCA made its new crowdfunding rules, there has been an upsurge in investment opportunities, such as mini-bonds – offered by currently fashionable concepts such as Taylor Street Baristas, Chilango Burritos, River Cottage etc. They are widely talked-up in daily newspapers, and through social media, and are clearly destined for a mass market. The Crowdcube platform itself uses a testimonial that states (emphasis added) :

"I don't think of myself as your average investor, but that's the point. Crowdcube gives ***everyone*** *access to loads of exciting companies."*

The Taylor Street Barista mini-bond, offering 8% pa interest on a four year term, was transacted through this platform, but also promoted in-store, via leaflets, stickers on coffee cups, etc to a general retail customer base. Chilango's Burrito Bond also promised 8% pa on a four year term, with a top up of two free burritos. River Cottage Bond offered 7% pa plus 10% restaurant discount. These exactly fit the description, and warning, in paragraph 3.11 of the CP :

" Given the current low-interest rates environment, we consider there to be a particular risk that unwary deposit-holders, focused on initially higher rates of return, may mistake or misunderstand the nature and risks of [mini-bonds]. Regardless of their design, these [mini-bonds] may be seen by savers as a relatively safe, fixed income investment and as potential alternatives to deposit-based products."

The FCA's observations in paragraph 3.11 could also apply to the area of P2P lending, and we note with interest the report headline in the Financial Times on 27 January 2015 : *"FCA to target P2P marketing over miss-selling fears"*. The report went on to say *"Concern is mounting at the watchdog that certain marketplace lenders, collectively known as "P2P" platforms, are deceptively marketing themselves by using the word "savings", even though they are offering consumers loans that carry much greater risk."*

The BSA does, however, agree with the important points made by the FCA in paragraphs 3.22 and 3.23. The percentage limit relies on self-certification. As FCA correctly observes :

"Consumers must take responsibility if they choose to invest more than this proportion of their assets."

It is also extremely sensible that the rules cater for electronic means of fulfilment, including electronic signatures where appropriate. This could be further clarified in the rules text as the words *"risk warning on paper or another durable medium, and obtain confirmation in writing from the client"* (COBS 22.3.2R) could, we feel, be misinterpreted so as to be at variance with paragraph 3.23.

Subject to the foregoing, our answer to Q11 is **Yes**. As regards Q12, the appropriateness test, our answer again is **Yes**, subject to the following point. Where the society administers the distribution itself, then it should perform the appropriateness test. But where the society might draw investors through a platform, or through an intermediary firm, that has already carried out generic appropriateness filtering on its clients, we do not think this needs to be repeated by the society.

Compliance checks

Q13 – **Yes**.

Q14 - **No**

Q15 – **Yes**, but with scope for nil return.

Appropriate compliance checks are essential to protect both potential investors and the society itself, but they should not be operationally onerous. We agree that records – which will almost certainly be electronic – should be kept for each sale. There should be systems and controls to deliver the necessary compliance, and there should be quality assurance – by testing, spot checks, sampling etc. But compliance department review of every single sale is not necessary – indeed it is a misdirection of resources. Periodic review of the approval process is also sensible, but bearing in mind that a society may well make an issue of CCDS at one point in time, and then make no further issues for many years, a simple nil return should be possible where no sales have been made. It is more important that systems and processes should be reviewed **prior to a further issue of CCDS** if there has been a lapse of time since the previous issue.

Q 16 : The proposals regarding existing investors are reasonable. We do not think there is likely to be any problem with existing investors in CCDS as retail issues have not commenced yet.

We have one final observation on the potential overlap between the concepts of **mutual shares** and **non-readily realisable securities**. Where a CCDS issue is not conventionally listed, it would appear also to fall within the definition of an NRRS. We think it would be desirable if the rules made clear that such mutual shares are subject only to the new rules proposed in this CP, and therefore carved out of the scope of NRRS.

BACKGROUND NOTE

The Building Societies Association represents all 44 UK building societies. Building societies have total assets of over £330 billion and, together with their subsidiaries, hold residential mortgages of over £240 billion, 19% of the total outstanding in the UK. They hold over £240 billion of retail deposits, accounting for 19% of all such deposits in the UK. Building societies account for about 28% of all cash ISA balances. They employ approximately 39,000 full and part-time staff and operate through approximately 1,550 branches.

BSA 29 January 2015