**Consultation Response**

# Consultation on draft innovation plan for financial services

**May 2016**

## About Co-operatives UK

Co-operatives UK is the network for Britain's thousands of co-operatives. We work to promote, develop and unite member owned businesses across the economy. From high street retailers to community owned pubs, fan owned football clubs to farmer controlled businesses, co-operatives are everywhere and together they are worth £37 billion to the British economy.

### *1 Does the UK's regulatory environment for financial services effectively support innovation?*

1.1 It's vital that regulation strikes the delicate balance between protecting the public from risk while allowing innovation, instead of just policing the system in a way which largely maintains the status quo at the expense of broadly beneficial innovation. In our areas of interest we currently see some good examples of the former, but unfortunately there are cases where the latter description is more accurate (see our answer to ***question 3***).

<u>*Co-opeative capital formation and Community Shares*</u>

1.2 The co-operative business form is distinctive in how it allows communities of interest (consumers, farmers, local people etc.) to pool capital to help meet their common needs and aspirations. Co-operative and community capital formation in the UK has a long legal and regulatory history, centred on the 'co-operative and community benefit society' corporate forms (collectively referred to as 'societies'). These legal structures have evolved in form and function specifically to facilitate co-operative capital formation.

1.3 Today member investment in societies is subject to well-calibrated regulation. In the last five years this enabling approach has seen a great innovation in community-led social investment, Community Shares, become firmly established across the UK. Community Shares are a means for people to buy a stake in a social enterprise they democratically own and control. Examples of Community Shares as innovation include communities buying a disused pier,[1] buying their local commercial harbour,[2] and, saving a local ferryboat service.[3]

1.4 Our Community Shares Unit (CSU) conducts market analysis. Even using the most conservative estimates based on what has been reported directly to the CSU, the community shares market has raised almost £60 million in the last five years, with upwards of £20 million invested in 2014 alone.[4] This in itself is not an inconsequential figure, but when set in the context of the wider social investment and alternative finance sector, this is particularly illuminating. Community shares now comprises over 10 percent of the overall annual social investment market and is the second largest form of 'crowdfunding' in the UK.[5] One social investment expert has described community shares as the most significant source of cheap, risky, long term growth finance available to social sector organisations. Certainly community shares are given a prominent role in Cabinet Office's new social investment strategy.[6]

1.5 Crucially societies are able to issue a unique form of 'withdrawable' non-tradable share capital to community investors outside of the financial promotions regulations. The cost of compliance with these regulations would make Community Shares impossible. Instead, the FCA has recognised that societies in form and function are strictly regulated by their registrar, the FCA Mutuals Team, to prevent them being misused for purposes that are not co-operative or for communal benefit. Furthermore the FCA has supported the development of practitioner-based self-regulation, led by the CSU. It works closely with the FCA, the Charity Commission, HMRC, HM Treasury and other Whitehall departments to establish voluntary standards and guidance for community share offers, expressed in the Community Shares Handbook.[7] It has also established the Community Shares Standard Mark, which is awarded to share offers that meet the criteria by a national network of licensed practitioners.[8] A recent survey of investors by the CSU found that 79 percent of respondents stated that the Standard Mark was 'moderately important', 'important', or 'very important' in their decision to invest.[9] This has been

[1] http://clevedonpier.co.uk/community-shares/

[2] http://www.portpatrickharbour.org/about_portpatrick_harbour_trust.html

[3] http://www.bristolferry.com/

[4] Community Shares Unit (2015) 'Inside the Market Report June 2015'

[5] Ibid

[6] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/507215/6.1804_SIFT_Strategy_260216_FINAL_web.pdf

[7] Community Shares Handbook

[8] http://communityshares.org.uk/further-support/community-shares-standard-mark

[9] CSU investor survey results

achieved without any amendment to regulatory statute, keeping costs down, while simultaneously driving standards up.

1.6 This particular regularity approach; which recognises the economic and social value of the Community Shares innovation, and seeks to minimise public risk while working with the distinctive features societies and with practitioners to avoid crushing regulation; should be an exemplar of how the right balance can be stuck. It demonstrates the immense value in having cross-Whitehall support which aligns social, economic, financial and regulatory policy.

***2 Do financial services regulators understand innovation in financial services and potential areas where new technologies and disruptive business models might emerge in the sector?***

2.1 There is always a danger that co-operative and mutual innovation will be misunderstood and mistreated by regulators used to dealing with for-profit investor-owned and controlled businesses. The evolution of laws and regulations tend to contain built in presumptions more attuned to, or directed at, traditional profit-driven and investor-owned business models.

2.2 The rise of open source online collaboration, time banking and peer-to-peer platforms demonstrates how new technologies allow for the creation of new non-traditional economic models, some of which take on mutual forms. As new financial variants of these arise it will be important that their distinctive natures are dealt with appropriately. This is especially so where motivations are mutual or social, and when innovations have the potential to redress imbalances of power which are themselves a source of risk.

***3 Are there any gaps in approach or areas where financial services regulators should be doing more to support innovative technology and disruptive business models in financial services?***

3.1 One major gap in the UK approach is the lack of regulatory clarity that would allow for the creation of Mutual Guarantee Societies (MGSs). In most European countries, including 20 EU member states, MGSs are a successful enterprise-led solution to the challenges of SME finance. These are essentially ‘business-to-business’ co-operatives through which sole traders, start-ups and SMEs can club together and offer 'mutual guarantees' to lenders, and thus improve their access to finance.

3.2 Each member business has an equal voting right and participates in electing the General Assembly and Board of Directors. Working together, businesses can then negotiate a better deal from banks, while for the banks the underpinning of the mutual guarantee provides partial security on otherwise unsecured enterprise lending. The risk is lower, so the price of money is lower. The deal flow is greater, and underpinned by peer review from member business, so access to capital is easier.

*A European innovation success story*

3.3 On one estimate, around 8 percent of all SMEs in the European Union that have benefited from the activity of MGSs. In 2013 MGSs in Europe issued over 25 billion EUR of new guarantees to support financing of enterprise. [10] As of the June 2015 1,344, 432 SMEs were recorded as active members of MGSs across Europe.[11]

3.4 The role of MGSs in supporting SMEs and thus promoting broad economic growth is recognised by DG Growth in the European Commission.[12] Meanwhile the OECD concluded in 2013 that mutual guarantee schemes internationally can be seen as representing: *"a key policy tool to address the SME financing gap, while limiting the burden on public finances."* [13]

*A timely innovation*

3.5 Information technology is core to the successful development of MGSs in Europe. The rapid development of digital platforms increasingly serves to reduce the barriers to participation. This is fast reducing the costs and timescales for MGS development and operation, meaning they can now develop more quickly and operate more effectively than ever before. The UK could utilise these technological innovations to leapfrog ahead in this area, but for regulatory barriers.

3.6 The rise of self-employment in the UK adds to the case for the use of mutual guarantees, as beneficial to the self-employed or micro-enterprises in their ability to pool access to finance through the provision of self-help guarantee structures.

*Regulatory barriers*

3.7 A previous attempt to introduce MGSs in the UK foundered in 1997, because the regulatory context was uncertain and unfavourable. Co-operatives UK has been working in a collaborative way with the FCA to attempt to clarify the regulatory interpretation.

3.8 The Financial Services Authority (FSA) completed work in 2012 with Co-operatives UK, in consultation with HM Treasury, on the regulatory treatment of MGSs in the UK. The FSA clarified that the best fit for any MGS found in terms of current regulated activities under current legislation is 'suretyship'. This imposes significantly greater capital requirements and

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[10] http://aecm.eu/about/mission/

[11] http://aecm.eu/wp-content/uploads/2015/12/scoreboard-H1-2015-2015-12-01.pdf

[12] http://ec.europa.eu/growth/access-to-finance/funding-policies/loans-guarantees/index_en.htm

[13] OECD Report (2013) SME and Entrepreneurship Financing: The Role of Credit Guarantee Schemes and Mutual Guarantee Societies in supporting finance for small and medium-sized enterprises

regulatory burdens than is the case in countries which have a bespoke scheme for MGSs, and is not a particularly good fit anyway.

3.9 As a result, there are far higher capital requirements and regulatory burdens than in any other EU country. Other countries have been able to specify MGSs in transposing EU directives, so that they are regulated in a distinct and appropriate way. Because the UK has no such arrangement, we essentially have regulatory gold-plating that blocks the entry to this innovative model of mutual finance.

*Proposed government action*

3.10 Co-operatives UK is therefore proposing a change in legislation, at the earliest appropriate opportunity, which would be deregulatory in spirit and consistent with the Government's Better Regulation initiative.

3.11 Government should seek to define a MGS and develop a regulatory treatment for MGSs in line with UK financial service regulation and related EU directives:

- A MGS is a co-operative or community benefit society, according to the Co-operative and Community Benefit Societies Act 2014, where:
    - membership is open to incorporated enterprises or sole traders;
    - and these members carry out the business of mutual guarantees, defined as the provision of guarantees to each other through the society for the purpose of improving access to and the terms of commercial finance for the members
- Mutual guarantees are added to the list of regulated activities set out in The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.
- The FCA, in liaison with the PRA and HM Treasury, will develop a system of conduct regulation for MGSs in line with its statutory objectives.

## *4 Is there more that financial services regulators could do to better utilise new technologies to deliver their own work more effectively?*

*Under-provision for mutual society data*

4.1 While the FCA Mutuals Team is a mutual business registrar/regulator, it is part of a financial services regulator, thus we are raising this issue in this consultation.

4.2 Management of society data by the FCA Mutuals Team is increasingly poor in comparison with that for community interest companies and companies. While data for the latter two is subject to high standards in accuracy, and is highly accessible in digital format free of charge, society data is expensive to access, inaccessible and often out of date. Societies are increasingly penalised in the workings of credit reference agencies and their clients because society data is out of date, inaccessible and costly to access. Indeed this particular issue is currently causing the Pension Protection Fund levy payments for a number of major mutual employers to more than double, despite their being no adverse changes in their underlying financials.[*] The combined penalisation cost involved here for just 5 consumer co-operatives is well in excess of £1 million this year alone.[**]

4.3 Improved digital provision for mutual society data is urgently needed to remove institutional bias and ensure these businesses operate on a level playingfield with their competitors.

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[*] PPF levy payments are based on a business failure risk score; the riskier an employer's position, the more they pay in the levy

[**] We are currently working on behalf of these co-operatives and would be happy to share details