

Level 10, 117 Lambton Quay
PO Box 5083
Wellington 6140

Ph: 0800 101 842
Fax: 04 471 2256

www.manchesterunity.org.nz

21 July 2017

Committee Secretariat
Finance and Expenditure Select Committee
Parliament Buildings
Wellington, 6011

By email: finance.expenditure@parliament.govt.nz
By email: select.committees@parliament.govt.nz

Dear Committee Members

REQUEST TO ENABLE FRIENDLY SOCIETY INSURERS TO RAISE CAPITAL UNDER
THE FRIENDLY SOCIETIES AND CREDIT UNIONS ACT

Introduction

- 1 Thank you for the opportunity to submit on the Friendly Societies and Credit Unions (Regulatory Improvements) Amendment Bill (the Bill).
- 2 Manchester Unity Friendly Society (Manchester Unity) seeks an amendment to the Bill to enable friendly society insurers to issue securities (as credit unions can currently do) to support their capital needs and to continue to meet their capital requirements as an insurer.
- 3 Manchester Unity is the largest traditional friendly society in New Zealand and is the only one licensed as an insurer by the Reserve Bank of New Zealand (RBNZ). The Society's principal purpose is to offer financial products, including insurance products, and fraternal services for the benefit of its 16,000 members.
- 4 The FSCU Act limits Friendly Society Insurers' access to Capital
The Friendly Societies and Credit Unions Act 1982 (FSCU Act) limits how friendly societies like Manchester Unity can raise capital. Like all firms, Manchester Unity can retain profits, but it has no shareholders and cannot raise capital by issuing shares.
- 5 This lack of access to quality capital places a serious limiting factor on the continuance, growth and development of friendly society insurers such as Manchester Unity, particularly as the Insurance (Prudential Supervision) Act 2010 (IPSA) has

introduced minimum capital requirements for insurers, which Manchester Unity must continue to satisfy.

Proposed Amendment to the FSCU Act

6 The proposed amendment (the Proposed Amendment) would provide friendly society insurers with access to additional capital by enabling them to issue a new class of security to raise funds, grow their business, and support their solvency.

7 The Proposed Amendment is based on a similar capital raising mechanism that Credit Unions already enjoy under section 107A of the FSCU Act, and would read (with highlighting to reflect the differences with section 107A of the Act):

50A Friendly Society may offer Friendly Society Securities

- (1) A friendly society that is a licensed insurer may, if authorised by and in accordance with its rules, ~~offer issue ordinary~~ friendly society securities ~~or preference friendly society securities to members~~ for subscription.
- (2) Friendly society securities—
 - (a) ~~are transferrable only between members can be transferred~~; and
 - (b) confer no voting rights upon holders.
- (3) In the event of a friendly society being wound up, claims for friendly society securities must not be paid until all creditors' claims ~~and claims relating to the shares referred to in section 107 have been paid~~ in relation to that friendly society have been paid.
- (4) In the event of a friendly society incurring losses that exceed its retained earnings and reserves, the value of the friendly society securities must be written down ~~accordingly in accordance with their terms~~.

8 The Proposed Amendment would define friendly society securities as follows:

Ordinary friendly society securities means friendly society securities which provide that the holder participates in the funds and property of the society in proportion to their financial interest in the event of winding up or dissolution of the society, where that financial interest is the nominal value of the securities.

Preference friendly society securities means friendly society securities which provide that the holder's financial interest ranks ahead of the financial interests of other members in the funds and property of the society and any branch of the society in the event of a winding up or dissolution of the society, where that financial interest is capped at the nominal value of the securities.

9 These definitions are based on the corresponding definitions of "ordinary deferred shares" and "preference deferred shares" in the Mutuals' Deferred Shares Regulations 2016 (UK). These draft regulations are proposed in the United Kingdom under the

Mutuals' Deferred Shares Act 2015, which was passed to address the inability of friendly societies in the United Kingdom to raise capital.¹

- 10 We discuss some of the detailed policy justifications in the Appendix of this letter and would be happy to provide the Committee with further information if requested.

It is vital that Parliament allows Friendly Societies to access new forms of capital to support their long-term stability

- 11 Our Proposed Amendment resolves a basic legal problem faced by friendly society insurers, and is limited only to those societies who are licensed insurers.² The issue they face has been recognised in the United Kingdom and is being addressed by the Mutuals' Deferred Shares Act 2015. We understand New Zealand's FSCU Act was based on the United Kingdom legislation.

- 12 The Proposed Amendment would also be consistent with the purpose and overall policy intent of the Bill to: "[A]mend the Friendly Societies and Credit Unions Act 1982 to reform the law relating to Friendly Societies and Credit Unions".³

- 13 The Proposed Amendment is vital and justifiable for the following reasons:⁴

13.1 Friendly Societies need to be able to adapt to the recent capital requirements for insurers – Insurance has always been a core business for friendly societies. However, friendly society insurers do not have the ability to raise capital that publicly listed companies, credit unions, co-operatives and building societies do, preventing them responding to the need for additional capital. This inability is now more acute following the introduction of the Reserve Bank's capital requirements for insurers under IPSA.

Our Proposed Amendment would support the unique business model of friendly society insurers; broaden options for consumers; allow the continuance of the insurance service that members value; and reduce the systemic risk to the insurance sector of the economy.

13.2 Without appropriate reform, Friendly Society insurers could be driven into inappropriate corporate forms through demutualisation – New Zealand has seen many of its oldest mutual organisations demutualise in the period between 1980 and 2000. A lack of access to capital has been used as the key justification for this corporate change.

The process of demutualisation removes the opportunity for insurance to be provided by a friendly society, under which members can provide for each

¹ HM Treasury Mutual Deferred Shares: Consultation on Technical Policy Details (4 August 2016).

² Manchester Unity is currently the only friendly society licensed as an insurer by the RBNZ. However, there are a number of friendly society insurers in Australia and abroad who may, in due course, decide to enter the local market and may wish to offer similar capital instruments in New Zealand.

³ Bills Digest No 2481: Friendly Societies and Credit Unions (Regulatory Improvements) Amendment Bill 2017 (5 May 2017).

⁴ International Co-operative Alliance – The Capital Conundrum for Co-operatives at 79 – Peter Hunt New capital instruments for financial mutuals – Ideas for co-operatives from the UK experience.

other's insurance needs on a mutual basis.⁵ Demutualisation means that consumers would no longer have non-listed, member owned options in the financial services marketplace.

- 13.3 A lack of capital limits Friendly Society Insurers' stability and the ability to develop new products – Access to quality capital permits businesses to consider innovations and investments into new business areas. The long term nature of friendly society ownership means that funds are not often available for this type of development.

Our Proposed Amendment would address this concern by providing friendly society insurers with new ways of obtaining capital to develop products and grow their business, improving their ability to offer consumers choice and compete in the marketplace.

- 13.4 Friendly Society insurers need access to quality capital – The need for friendly society insurers to raise capital is only likely to increase given the RBNZ's focus on the capital quality of licensed insurers.

Our Proposed Amendment would improve friendly society insurers' access to quality capital (both to absorb losses and improve liquidity) to support their regulatory solvency position.

- 13.5 Friendly Societies need an alternative to raising debt – Friendly societies are largely prohibited from borrowing under section 51 of the FSCU Act. Even if friendly societies were able to borrow, there is inevitably a limit on the amount of debt that can, or should, be raised by a mutual organisation and, more importantly, debt does not count as solvency capital under the Solvency Standards for insurers.

- 13.6 Friendly Societies should be able to access capital to consider tactical acquisitions – Friendly society insurers lack the capital to take advantage of tactical acquisitions. By helping to facilitate the growth of the business through acquisition, new capital could help friendly society insurers to compete.

- 13.7 Members' contributions to capital can build stable mutuals – There are several examples locally and globally where members and others contribute to the capital base of co-operatives. Examples include the Fonterra Shareholders Fund, which shows how mutuals can enlist their members and others in raising capital through the issuance of co-operative shares.

Our Proposed Amendment would enable friendly societies to use this investment to build stronger mutual ties between members and institutions, and seek new sources of capital from non-member organisations that believe in the principle of mutuality.

⁵ This trend is also evident in the United Kingdom. See the All Parliamentary Group for Mutuals, Windfalls or Shortfalls – The true cost of Demutualisation (<http://www.mutuo.coop/windfalls-or-shortfalls-the-true-cost-of-demutualisation/>).

- 14 The Committee would, by granting friendly society insurers the power to raise new capital, allow friendly societies to conduct their business with the confidence that, if necessary and if permitted by their rules, they could build capital in a variety of ways beyond slowly growing retained-earnings.

Conclusion

- 15 Manchester Unity would welcome the opportunity to make further oral submissions on the Bill when it is next before the Committee.
- 16 We ask that the Committee takes up the proposal and refers it to the Ministry of Business, Innovation and Employment (MBIE) for detailed consideration.
- 17 We would be happy to work with officials on the drafting and any further policy considerations, along with our legal advisers, Chapman Tripp. We will also actively engage with the RBNZ as part of the current IPSA review to seek changes to the Solvency Standards which support any capital flexibility provided by the changes sought to the legislation.
- 18 Thank you again for the opportunity to submit on the Bill. If you require any further information, please do not hesitate to contact me.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Sanjiv Jetly', with a long horizontal line extending to the right.

Sanjiv Jetly
Chief Executive Officer

APPENDIX – POLICY JUSTIFICATIONS

Why is the Proposed Amendment needed?

19 As mentioned, the Proposed Amendment addresses a key problem faced by friendly society insurers that arise from the outdated provisions of the FSCU Act. It is a problem already addressed in similar circumstances in the United Kingdom.

20 The Proposed Amendment is a vital component of improving the legal infrastructure for friendly societies in New Zealand – something that has been long neglected in past reforms that have focussed almost exclusively on Credit Unions.

21 The Proposed Amendment would, for the first time, permit friendly society insurers registered under the Act to issue securities to support their capital requirements, as credit unions can do as a result of previous amendments. It is also narrowly tailored to licensed insurers, and will not have unintended spill-over impacts on the dozens of smaller friendly societies and working-men's clubs that are currently registered under the FSCU Act.

The Proposed Amendment would protect Mutuality

22 Under the proposal, the decision on whether to issue friendly society securities would need to be made by members – the friendly society insurer's rules must allow it and may restrict the use of the securities in whatever way the members deem fit. This protects basic member control and the mutuality on which societies are based.

23 The Proposed Amendment also prevents the use of friendly society securities for demutualisation by conferring no voting rights on holders. As a result, members will continue to retain collective control of the friendly society insurer and can direct its course.

The Proposed Amendment is consistent with International Developments

24 The United Kingdom has recognised the need for friendly societies and mutual insurers to have access to quality capital and has recently passed the Mutuals Deferred Shares Act 2015 (the MDSA).

25 The MDSA sought to address the challenges faced by friendly society insurers and other mutuals by legislating for mutual insurers to be able to issue a new type of capital instrument: Mutual Deferred Shares.⁶

26 The MDSA enables mutual insurers to issue ordinary and preference deferred shares. The main difference (which is reflected in our Proposed Amendment), is in the degree of subordination of the deferred shareholder members' interests.⁷

27 Mutual insurers may prefer to issue one type of deferred share or the other depending on their constitutions, intended investors and business aims. Preference shares potentially allow for a clearer definition of shareholder members' distinct interests

⁶ The Act received cross-party support in both the House of Commons and House of Lords and received Royal Assent in March 2015.

⁷ The interests of 'ordinary' deferred shareholders rank equal to the interests of non-shareholder members of the mutual, while those of 'preference' shareholders rank just above; both classes of security rank below policyholders and non-subordinated creditors.

compared to non-shareholder members, however 'ordinary' deferred shares may provide a stronger form of core capital for solvency purposes.

- 28 The Proposed Amendment has been drafted such that friendly society insurers will have the power to issue either ordinary or preference friendly society securities (only if their rules allow them to do so), and will permit them to set the terms of those securities as they see fit (just as an ordinary company would).⁸

The Proposed Amendment would enable friendly society insurers to issue securities recognised as capital by the RBNZ Solvency Standards

- 29 Friendly society securities issued by a friendly society insurer could be recognised by the RBNZ for solvency purposes under the Solvency Standards in much the same way as Credit Union Securities are already recognised for solvency purposes.

- 30 Specifically, the Solvency Standards for Life and Non-Life Insurers issued by the RBNZ define capital for a licensed insurer (such as Manchester Unity) as the total value of:

30.1 Ordinary Shares;

30.2 Perpetual Non-Cumulative Instruments; and

30.3 Credit Union Securities.

- 31 Each of these types of security must meet qualifying criteria to be recognised as capital in the Solvency Standards. Credit Union Securities have specific qualifying criteria.

- 32 If the Proposed Amendment is made, we would discuss with the RBNZ whether the proposed Friendly Society Securities meet the Perpetual Non-Cumulative Instruments criteria under the Solvency Standards, with or without amendment, or whether similar qualifying criteria to Credit Union Securities needs to be developed for Friendly Society Securities. We believe that any required changes would be within the intent of the relevant Solvency Standard.

How Friendly Society Securities will work in practice

- 33 The Proposed Amendment, if it becomes law, would empower friendly society insurers to issue ordinary or preferred friendly society securities, provided their rules allow them to do so, and provided they are a licensed insurer.

- 34 That would leave the society's rules or the terms of issue to decide on the details of the rights attached to the securities, as long as the securities cannot be withdrawn, confer no voting rights on holders, and meet the definitions in the Act.

- 35 Once those conditions are met, and depending on the terms of issue, they may then be purchased by members, individuals or institutions and in turn provide capital to the friendly society insurer.

⁸ In practice, to be recognised as capital under the Solvency Standards issued by the RBNZ, the friendly society insurer would need to ensure that the terms of issue reflect qualifying criteria for capital under the Solvency Standards.

36 Outside New Zealand, friendly societies have issued similar types of securities, and members often purchase modest numbers of shares. For example, with the recent Desjardins Group (Canada) offer of 'Federation Shares', the entire allocation of CA\$1.2 billion was purchased by individual members, typically making investments of between CA\$2,000 and CA\$4,000 each.

The Purpose of Friendly Societies

37 Friendly societies can trace their origins back at least to the 1700s in England, when mutual insurance began to provide security for large numbers of working people.

38 Friendly societies are owned by their members. Ownership is expressed commonly – no individual can take away their 'share' of the assets unless the mutual bond is broken through demutualisation.

39 Friendly societies are established for a shared member purpose, but generally access to their services is open to anyone, as is membership.

40 Friendly societies all operate some form of democratic voting system, with each member valued the same – one member, one vote. This contrasts with shareholder owned companies where votes are distributed according to capital ownership.

41 Friendly societies and other mutually owned entities do not have share capital in the way that listed firms and many co-operatives do. Instead, the capital accumulated in these firms has been built up over many years from retained earnings and is collectively owned by customer members.

42 Given their business model, friendly society insurers such as Manchester Unity were not designed with capital market investors in mind. The long-term approach adopted by friendly societies is often seen as a strength, as the patient build-up of a surplus retained for the benefit of members can allow for the society to concentrate entirely on its business and customers, rather than meeting the needs of external investors.

43 Today, friendly society insurers such as Manchester Unity operate in a market which is very different to that of their predecessors. Shareholder-owned companies are now the norm, and external capital raising is often an essential component of insurers' continuance, growth and investment. However, friendly society insurers cannot issue shares, which prevents them accessing a much wider pool of long term capital via the equity markets.

44 Accordingly, changes need to be made in New Zealand to the enabling legislation as has been recognised overseas. Such changes cannot be delayed, as the need for capital for friendly society insurers is a current issue.