

Update for Local Authority Members¹

June 2022

EXECUTIVE SUMMARY

Stakeholder support for establishing a regional mutual bank for the south west remains strong.

South West Mutual was cited in the Government's Levelling Up White Paper as an example of the local financial institutions needed to drive regional prosperity.

However, progress has been severely hampered by disruption from the coronavirus pandemic and deterioration in economic conditions for investment.

Furthermore, there are a number of material barriers that need to be overcome:

1. Competition law barriers preventing co-operation between regional mutual banks
2. Regulatory barriers to the creation of mutual banking start-ups
3. Lack of patient capital for purpose-led financial institutions

Competition law issues (1) would require Government intervention to solve, which is considered unlikely. Preventing regional mutual banks working together to share costs and services does not itself prevent the establishment of such banks, but it does make it harder.

The Mutuals Bank Association is working with Parliamentarians and leading advisory firms to address the regulatory barriers to creating mutual banks (2), and to make the case for investment in mutual banks from the Dormant Assets Scheme to address the 'market failure for mutual capital' (3).

In response to these issues, the Board has adopted a revised strategy of introducing banking services in stages, starting with a business loan fund aimed specifically at smaller farms that want to invest in nature friendly farming practices – the South West Agroecology Fund.

The overall objective remains to obtain a full banking licence, and to introduce a full range of high street banking services to households and businesses in the region over time. The business model remains closely aligned to that originally presented to investors with modifications to take account of changes in banking technology and consumer trends.

The next step is to complete legal and operational preparations and raise finance to launch the South West Agroecology Fund in late 2022 / early 2023.

¹ This document has been prepared for the following local authorities who collectively hold £370,000 (just over half) of the issued share capital of South West Mutual: East Devon DC, Mid Devon DC, Plymouth City Council, South Hams DC, Teignbridge DC, West Devon BC.

THE SOUTH WEST MUTUAL PROPOSITION

SWM is seeking to establish a regional mutual bank based in and focussed on Cornwall, Devon, Somerset and Dorset.

Its objective is to provide straightforward, honest, transparent and accessible high street banking services to households and small businesses including current accounts, savings, overdrafts loans and mortgages.

As a purpose-led, ethical and mutually owned business, we aim to serve business and communities that are currently underserved and to generate positive social, economic and environmental impacts for the region.

The bank will require capitalisation of at least £25 million to be raised through issuing shares on which dividends will be paid, with target returns of 5%-6% per annum over the long term.

PROGRESS TO DATE

The process of applying for a banking licence takes many years, progressing through three stages of 'pre-application', 'application' and 'mobilisation'. SWM is in the 'pre-application' phase and has submitted a draft regulatory business plan, received written detailed feedback, and had two formal meetings with banking regulators (PRA and FCA).

However, progress has been severely hampered by disruption from the coronavirus pandemic and deterioration in economic conditions for investment.

Furthermore, three significant barriers have previously been discussed in the 2021 Annual Report and in email updates to members. They are summarised below with the latest updates.

(1) Competition law barriers

The Directors undertook legal due diligence on aspects of the proposed regional bank business model to ensure compliance with competition law. We consulted leading competition lawyers and had a number of discussions with competition authorities.

Although a case can be made for co-operation among regional banks being in the public interest, the Directors concluded that the application of competition law in practice creates an unacceptable level of legal risk to SWM of pursuing this.

It is within the powers of the Government to allow for such collaboration and provide legal certainty, but we do not anticipate that this will be forthcoming. This risk was set out in the original share offer document.

Furthermore, the Directors concluded that the regional focus of the Society's banking activities is better managed through applying geographical criteria to each product, where relevant, rather than to the location of the customer at the time at which they first become a member. This change is informed by a combination of considering risk management and customer service on a product-by-product basis.

In other words, competition law as it has been implemented in the UK creates an unacceptable legal risk for a bank that seeks to serve members **only** from a defined and published geographical area and especially if it has any commercial or other relationships with other regional banks.

This is disappointing, as competition law as applied in other European countries, for example Germany, appears to not create this barrier to networks of regional mutual banks. Such networks are commonplace among the UK's key competitor economies.

(2) Mutuals law – barriers to raising capital

In May 2021 a long-awaited ruling from the FCA determined that cooperative societies registered under the Cooperative and Community Societies Act 2014 were not able to issue shares at different prices as is usual for private companies seeking to raise start-up investment.

The implication is that earlier investors that take higher risks cannot earn higher returns through capital gains on their shares. It is unattractive for early-stage investors to only receive the same returns as later stage investors that take less risk.

In response, the Mutual Banks Association has been developing a new corporate structure with advice from PricewaterhouseCoopers and Anthony Collins Solicitors. This structure will be registered under the Companies Act 2006 avoiding the problems associated with the Cooperative and Community Societies Act 2014. It will also have the following features:

- Corporate purpose defined as promoting the 'common good', not private profit
- Mutual ownership and governance (one member one vote)
- Ability to issue shares at different prices over time to reward early-stage investors
- Share capital that qualifies as equity capital for the purposes of banking regulations

Feedback on the new structure is currently being sought from banking regulators. The risk that regulators might not accept a mutual banking structure was set out in the original share offer document.

(3) Lack of patient capital

The features of mutuals that underpin benefits to customers and the broader community are also those that make them unattractive to venture capital investors seeking rapid growth and high financial returns.

Financial mutuals such as building societies and insurance companies that were formed many decades ago were able to start small and grow their own capital reserves slowly. For example, the last building society to be established, the Ecology Building Society, was allowed to start taking deposits and making mortgage loans with only £5,000 of initial capital.

The modern era of financial regulation means this is no longer possible.

Although SWM has attracted patient investors interested in a combination of positive social and environmental impacts with sensible financial returns over a longer-term timeframe, it remains the case that venture capital investors that specialise in financing start-up ventures, that are by their nature more risky than well-established companies, seek investment returns well beyond those that it is sensible for a financial mutual to seek to deliver.

One potential source of patient capital for mutual start-ups is through the Dormant Assets Scheme, which takes unclaimed savings and financial assets from banks and other financial services firms and applies them to good causes such as improving financial literacy and financial inclusion.

The Mutual Banking Association is making the case to the Government that investment in regional mutual banks would be an appropriate use of such funds.

NEW STRATEGY FOR LAUNCHING BANKING SERVICES

In light of the considerable barriers to obtaining a full banking licence that are summarised above, and following a comprehensive review of options by the Board, a new strategy has been adopted to phase in banking services over time.

This strategy has a number of benefits including commencing trading much sooner by initially launching services that do not require a banking licence.

South West Agroecology Fund

The first product will be a revolving £20m business loan fund to finance the transition to nature friendly farming practices – the South West Agroecology Fund (SWAF).

SWAF will fill a funding gap for food and farming businesses making significant changes to their production methods, sourcing policies, retail and distribution channels to transition away from intensive agriculture. Research has identified that there is insufficient bank finance available for such businesses, particularly smaller farms, new entrants and tenant farmers.

Agriculture, horticulture and food processing are significant economic sectors in the region, and particularly important for maintain rural employment, incomes and cultural heritage.

Agroecology is a nature friendly approach to agriculture that seeks to eliminate chemical inputs, diversify production, improve biodiversity, ecosystem and soil health, reduce carbon emissions and maximise production synergies within the farm.

It is focussed on outcomes and applying local know-how rather than following standardised processes. According to the Food, Farming and Countryside Commission, a transition to agroecology in the UK could:

- Reduce carbon emissions by upwards of 70%
- Support species abundance on and beyond farms, restore ecosystems, rebuild soil health and improve water quality
- Grow enough healthy and sustainable food for all
- Support rural business and livelihoods

Agroecology is supported by the United Nations FAO (Food and Agriculture Organisation) and embedded in the UN Sustainable Development Goals.

SWM is currently developing the operating and legal structure for the fund and, subject to securing sufficient investment, plans to launch SWAF in late 2022 / early 2023.

Key changes to banking business model

The purpose, mission, scale, target customers and product range planned for the bank remain closely aligned with those presented to investors and members in 2019.

However, other elements of the business model have been revised in the light of detailed market research, due diligence, and developments in the banking industry, including evolving consumer trends and technological advances.

Branches - The evolution towards digital banking services has accelerated as a result of the pandemic. At the same time, government and industry initiatives have been launched to maintain access to cash and branch banking services through Bank Hubs and Post Office access. In this context, launching with a cash handling branch network undermines the commercial viability of the proposition. Instead we plan to introduce a network of face-to-face customer service points over time to augment digital and telephone banking channels.

Technology – We are constantly reviewing banking technology providers as the market is developing rapidly. Our current configuration offers greater functionality and flexibility than the technology providers and solutions described in the Founder Share Offer Document, which are unlikely to be the ones selected.

Timetable – For the reasons set out above, the target launch dates and milestones set out in the Founder Share Offer Document are no longer valid.

SUMMARY FINANCIAL INFORMATION

The past three years summary financial information for South West Mutual Limited is set out below. The most recent year is in the process of being independently audited. The previous two years are extracted from the audited financial statements.

	MAR 2022	MAR 2021	MAR 2020
	£'000	£'000	£'000
	<i>Unaudited</i>	<i>Audited</i>	<i>Audited</i>
Grants and other operating income	41	179	211
Staff and directors	137	241	343
Consultants and business services	37	115	41
Marketing, market research, events and travel	9	27	40
Office and administrative costs, including depreciation	13	14	22
Audit and accountancy	6	13	15
	202	410	461
Deficit for the year	161	231	250
Share capital	720	645	510
Cumulative deficits	709	548	318
Net assets	11	97	192

Since the year end a further £20,000 in grant funding has been received, and further grant applications are in progress alongside discussions with potential investors in SWAF.