Friendly Societies of Australia

23 May 2017

Mr Greg Hammond
Review Chair
Review of Reforms for Cooperatives, Mutuals and Member owned firms

By email: coopsandmutualreview@treasury.gov.au

Dear Mr Hammond

Review of reforms for cooperatives, mutuals and member-owned firms

The Friendly Societies of Australia (FSA) appreciates the opportunity to provide this submission on barriers which impede our members from accessing capital and on the pros and cons of inserting a definition of 'mutual enterprise' into the *Corporations Act 2001*.

The FSA represents friendly societies regulated by APRA, the majority of which are member-owned mutual organisations. FSA members provide investment products, financial services, healthcare, retirement living, aged and home care services to some 800,000 members. Collectively, our sector manages around $7 billion in funds, and in 2015, paid out more than $675 million in benefits.

Prudential regime

Mutual friendly societies are not permitted under APRA's prudential framework to issue capital instruments that qualify as the highest quality form of regulatory capital: Common Equity Tier 1 (CET1). The only directly-issuable capital instruments that qualify as CET1 are 'ordinary shares'. Mutual friendly societies cannot issue ordinary shares without demutualising.

Mutual friendly societies should be given capacity within APRA's prudential framework to issue instruments that qualify as CET1 but are consistent with the mutual model.

Corporations Act

Under Part 5 of Schedule 4 of the Corporations Act, any issue of shares by a mutual friendly society potentially creates the risk that ASIC will deem the share issue is a demutualisation of the company. ASIC has the power to rule that a share issue is not a demutualisation but entities can't be absolutely certain of ASIC's view on any particular proposal.

More clarity and certainty is needed for mutual friendly societies that issuing securities that are consistent with the mutual model will not trigger the demutualisation provisions.

This could be achieved by:

- ASIC adopting a more explicitly supportive approach to mutual friendly societies wishing to issue capital instruments that are consistent with the

mutuality tests in ASIC Regulatory Guide 147 Mutuality – Financial institutions (RG 147), or
- legislative changes to reduce ASIC's discretion and provide greater certainty.

Agreement on the key features of mutuality will allow for a definition of mutuality to be inserted into the Corporations Act and this is a highly desirable outcome.

Uncertainty about exemptions from demutualisation provisions

Mutual friendly societies issuing regulatory capital instruments could trigger demutualisation disclosure and process requirements, even if they have no intention to demutualise.

These companies must then go through a costly process to provide notice of a meeting or consent process and a number of documents to members and ASIC including a disclosure statement, an estimate of the financial benefits and an independent expert's report.

Further, it would be a significant challenge to explain to members that a proposal is not a demutualisation even though the process and disclosure requirements are subject to the 'Demutualisation' section of the Corporations Act.

As noted above, ASIC can exempt companies from the Part 5 'Demutualisation' requirements. However, the regime leaves significant uncertainty for companies and significant discretion for ASIC about this exemption power.

ASIC's Consultation Paper 10 Mutuality that led to RG 147 notes that: "The thresholds that trigger this demutualisation regime are quite low and in many cases a company will trigger Part 5 with no intention to demutualise."

RG 147 is ASIC's attempt to provide as much certainty as possible about its use of the exemption power but it would be desirable if mutual friendly societies had greater clarity and certainty that issuing regulatory capital instruments that are consistent with mutuality will not trigger the demutualisation provisions.

This could be achieved by:

- ASIC adopting a more explicitly supportive approach to mutual friendly societies wishing to issue capital instruments that are consistent with the mutuality tests in RG 147, or
- legislative changes to reduce ASIC's discretion and provide greater certainty.

A legislative solution to the uncertainty about what does, and what does not, constitute a demutualisation could be achieved by amending the Corporations Act to insert a definition of a mutual enterprise.

The FSA also advocates the establishment of a Mutual Capital Instrument (MCI) because the Corporations Act currently only recognises two types of security, shares and debentures, in relation to a company.

The main features of the new instrument would be that it could only be issued as either a permanent or long term instrument not callable by the investor and in its basic form would be entitled to a non-cumulative return out of profits based on a formula.

An MCI would be an equity investment, distributions would be frankable (if mutual friendly societies were allowed to be franking entities for this purpose) and it would entitle the holder to one (limited) membership irrespective of the amount held. It is important that the Instrument is classified as a new security in order to avoid any possibility that it is a share which might result in involuntary (and probably irreversible) demutualisation or a debenture which would prevent it from being classified for regulatory purposes as CET1.

Arguably, the demutualisation provisions in Division 316 of the *Income Tax Assessment Act 1997* are a barrier for friendly societies that wish to demutualise in the future if it has shares on issue at the time. However, we understand that this review is focused on mutuals that wish to continue to flourish under a mutual structure.

Defining mutuality

According to ASIC's consultation paper leading to RG 147, mutuality fundamentally involves a commonality of interest between an entity's owners and customers.

"The Courts have held that there are two characteristics which are usually found in a mutual organisation: effectively, that every member must have a voice in the administration of the association and any surplus must ultimately come back to the members."

The paper notes the risk of competing claims between investor shareholders and customers, e.g. raising prices to maximise profits versus running a service to members or payment of dividends versus subsidisation of product related expenses

"When considering a proposed constitutional modification or share issue, ASIC assesses whether the proposal would result in the company being run for the purpose of yielding a return to shareholders. To this end, ASIC analyses the relationship between the company and its members by reference to the economic relationship test and the governance relationship test, both of which contain a number of limbs.

"In recognition of the fact that some mutual companies have, or will seek to have, a mixture of ordinary members and investor shareholder members, ASIC will apply this purpose test to mean 'dominant' purpose. A company may seek to yield a return to shareholders and remain a mutual, provided that such a return to shareholders does not become the dominant purpose. The principles of mutuality will be considered in arriving at a determination as to what a company's dominant purpose it. For example, if a company substantially meets both the governance and economic relationship tests, it is likely that the company has a dominant purpose to provide services to members, and not a dominant purpose of yielding a return to investor shareholders."

FSA sees the need for a debate across the wider mutual and co-operatives sector about the features that are the essence of mutuality. Agreement on the key features of mutuality will allow for a definition of mutuality to be inserted into the Corporations Act.

A definition of mutuality within the Corporations Act will:

- provide clarity for stakeholders, including regulators, to distinguish mutual companies from investor-owned companies (e.g. for the purposes of regimes such as taxation, financial services regulation and prudential regulation)
- provide capacity to adapt other elements of the Corporations Act, e.g. directors' duties, to the mutual model
- improve capacity to promote the distinct identity, size, scope and contribution of the mutual sector
- give 'transferring financial institutions' more certainty about the 'demutualisation' provisions in the existing Part 5 of Schedule 4 of the Corporations Act.

Defining mutuality in statute will allow the sector to more easily pursue policy that provides fair treatment for member-owned organisations. Stakeholders and regulators will be able to 'ring fence' treatments for mutuals without worrying that they will be exploited by non-mutuals. The definition will need the flexibility to cover the broad range of mutuals, i.e. customer-owned, employee-owned, producer-owned, and various combinations of these.

Debate about the meaning of mutuality opens up many possibilities for the mutual sector and allow the sector to revisit the discussion of how the presence of investors alongside 'members' can work with the mutual model.

However, there are obvious risks to the mutual model if the position of investors compared to members is not carefully balanced. The current regime for 'transferring financial institutions' prohibits a mutual from restructuring in a way that "would have the effect of converting the company into a company run for the purpose of yielding a return to shareholders."

A definition of mutuality must be well-considered and many internal and external stakeholders will have a view and must be allowed the opportunity to have their view taken into account.

While the need for a definition of mutuality in the Corporations Act is clear, the terms of the definition require further discussion. A recommendation that supports the need for a 'mutual enterprise' definition will give mutual friendly societies and the wider mutuals sector the certainty to justify committing time and resources to a complex policy discussion.

If you have any questions please contact Tony Connon, FSA Treasurer on 0412 412 377 or by email, tonyconnon@iinet.net.au.

Yours sincerely

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