



Designing Capital Instruments for Mutual ADIs

Financial Policy Brief
FPB 2017-05: 17 May 2017

Author:
Professor Kevin Davis

FINANCIAL POLICY BRIEF

Designing Capital Instruments for Mutual ADIs

FPB 2017 – 05: 17 May 2017

In this FPB written as a submission for the [Hammond Review](#) into Reforms for cooperatives, mutuals and member-owned firms Professor Kevin Davis advocates allowing mutual ADIs to issue preference shares to members (and others) to raise external regulatory capital. He also argues that “bail-in” requirements for such securities to meet regulatory capital requirements need to be reconsidered, both in terms of their rationale and, if maintained, their design.

Australian mutual deposit takers, such as mutual banks, credit unions and building societies (mutual ADIs) face significant restrictions on their ability to grow and compete with joint-stock banks because of their inability to access external capital. To increase capital to meet regulatory requirements associated with growth they need to generate surpluses from their activities, which can then be retained as additions to capital. But to generate a higher surplus involves widening the interest rate spread between borrowers and depositors (or generating more fee income) which inhibits the use of their services by customers and their growth rate. Consequently, there is a limit to the growth rate they can achieve without reducing capital adequacy.¹

Algebraically, that limit can be shown for a simplified case to be given by:

$$g^* = ROE = ROA/(E/A)$$

where: g^* is the growth rate possible while maintaining a constant capital ratio (E/A); E is equity capital; A is assets; ROE is return on equity and ROA is return on assets. The intuition is straightforward and best illustrated by example. If assets grow by 10 per cent, then it will be necessary for equity capital to grow also by 10 per cent to keep the capital ratio constant. Since the only source of capital is retained profits, that requires a 10 per cent return on equity (ROE). Anything less and the capital ratio will fall, and conversely a higher ROE will see the capital ratio increase.²

¹ In this discussion capital adequacy refers to the non-risk-weighted capital ratio. If risk-weighted capital adequacy (as per the Basel capital requirements) is to be considered, a simple modification to the formula incorporating the average risk weight of assets is possible.

² If risk weighted capital is being considered, changes in the capital ratio could also be due to changes in the average risk weight of assets.

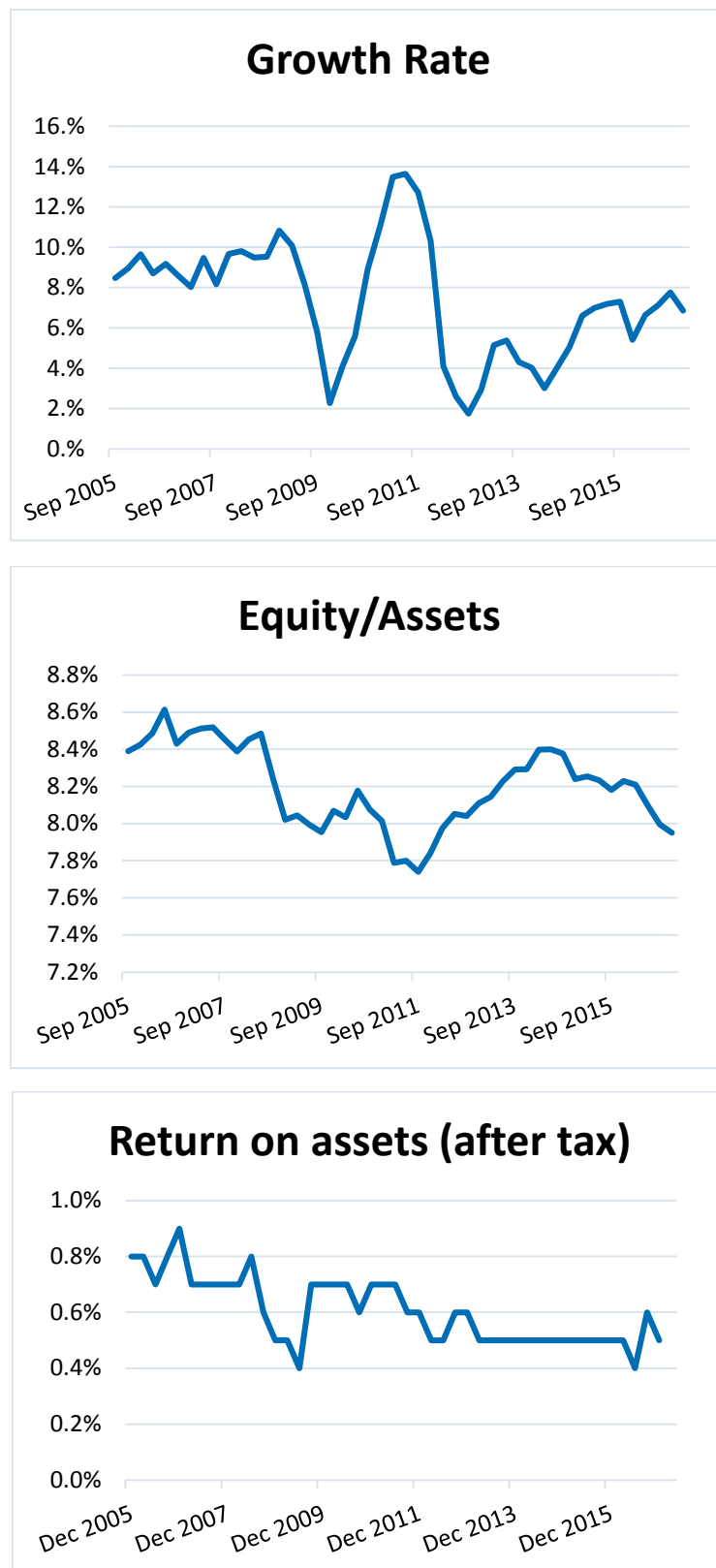
This relationship is evident in recent data for the mutual ADI sector as a whole. Figure 1 (panel 3) shows that the ROA for the sector has averaged around 0.5 per cent in recent years. At a capital ratio of around 8 per cent this means that the natural growth rate of assets is around 6.25 per cent. From (approximately) 2012 to 2014 the growth rate was lower (panel 1) and the capital ratio increased (panel 2) and since then a higher growth rate has seen the capital ratio fall.

Joint-stock ADIs must also ultimately generate an adequate ROE for shareholders if they are to continue to access further external capital. In that regard there is a similar longer-run constraint on their growth rate. But they are able to adapt to changes in business opportunities in the shorter run by raising external capital – unlike mutual organisations, giving them a competitive advantage.

Australian regulators and legislators have made it difficult for mutual ADIs to access external capital, and have impeded internal accumulation of capital via tax policy. Indeed, because regulators require regulatory capital to be permanent, prudential regulation has effectively created a “Catch 22” situation preventing the formation of new mutual ADIs.³ Regulatory capital adequacy policies have also influenced the nature of business activities of mutual ADIs, through risk-weighting of capital requirements.

³ See Kevin Davis "[Credit Unions: Can They Survive](#)" *Agenda* 4, 3, 1997, 317-328

Figure 1: Mutual ADI Growth and Capital



Source: APRA Quarterly Banking Statistics

The Tax Issue

Much discussion and policy change has occurred over decades regarding taxation of mutual ADIs, most recently focusing on the inability of mutual ADIs to distribute franking credits to members. How much (if any) of a competitive disadvantage this leads to is problematic, but would be largely resolved if mutuals were able to attach franking credits to distributions paid on securities providing external capital for the ADI. Rather than considering alternative taxation arrangements for mutuals (which could be justified if raising of external capital is prohibited) this paper focuses on the merits and possible design of external capital instruments for mutual ADIs. There is a fuller discussion of the taxation issues in the appendix.

The 'Bail-in' Requirement

Under the Basel 3 rules for regulatory capital, securities other than common equity are only eligible for inclusion if they contain “bail-in” or “write-down” clauses. Whether these contingent capital instruments are, in fact, a good idea is open to question,⁴ and they create particular problems for mutual ADIs. Specifically, because mutual ADIs work on a one-member one vote principle and do not make distributions of profits on the minimal amount of contributed member equity, conversion of such bail-in instruments would require the creation of an alternative form of equity instrument. APRA has previously suggested that a “Mutual Equity Interest” could be created, although the difficulties in appropriately designing such securities are large and their implications for mutual management and governance unclear.⁵ They do not appear to be a feasible option.

One possibility would be to design contingent capital instruments for mutual ADIs which have only a write-down clause. This approach has been adopted in a number of jurisdictions both for joint-stock banks as well as mutuals or government-owned banks where conversion into equity would be problematic. A number of cooperative/mutual banks (Rabobank, for example) have issued such securities.

In principle, there is no reason not to adopt such an approach provided that the write-down trigger is specified in such a way that investors in such securities can have comfort that they are not exposed to arbitrary write-downs and losses (and that management has strong

⁴ See Kevin Davis “Bail-In securities: Is the Game worth the Candle” [ACFS Financial Policy Brief 2016-03](#), September 2016

⁵ See Kevin Davis “Mutual Equity Interests: An Oxymoron” [ACFS Financial Regulation Discussion Paper 2013-03](#), November 2013

incentives to appropriately manage risk taking and capital planning to prevent a situation occurring which would trigger a write-down). Indeed, the difference between that and an investment in a debt security issued by a mutual ADI is largely a matter of degree. In the latter case, if the mutual becomes insolvent, the debt holder will not receive a full return of their investment – suffering a “write-down” dependent upon the extent of the insolvency. In the case of contingent capital, the investor will face a different trigger event (a decision by APRA or a capital adequacy event) and the size of the write down will depend upon the decision by the regulator or mutual board as to the amount of write down needed to restore the mutual’s capital position.

Because issuance of such securities reduces the ability of the mutual to generate internal capital (since it must pay distributions on the securities, rather than retaining profits) there is a case for limiting the scale of issuance (ie imposing some capital structure limitations).⁶ This would imply imposing some maximum on the amount of AT1 and T2 capital relative to the amount of CET1 capital of the mutual ADI.

In designing such a security, a number of issues need to be faced. First, would such a write down be temporary or permanent? Arguably, if the ADI returns to a position of viability, the write-downs could be reversed over time – although this would limit the ability of the mutual to further grow its capital base from accumulated profits. Second, what consequences for governance and control of the mutual stem should follow from a write-down event? Clearly, those accountable for the poor performance (the board and senior management) should incur some cost such as removal from office or restricted remuneration. Third, what governance and control rights should holders of such securities have prior to and after any such write down? Even allowing one vote per holder could create potential control issues, since a consortium of holders could be large enough to create a majority at an AGM. (In general, the participation rate of members in voting at mutual ADI AGMs is very low, although where special resolutions such as proposals for demutualisation are held, much greater participation is observed).

The Basel 3 requirements impose constraints on what are allowable characteristics for securities to be classified as AT1 or T2 capital. These include:

- Non-cumulative distributions. For this to be acceptable to potential investors there need to be restrictions on the issuer’s ability to suspend distributions and consequences which limit the issuer’s willingness to do so. For joint-stock

⁶ It can be expected that the rate paid on such securities would exceed that on funding assets alternatively by deposits due to the higher risk involved for investors.

companies, there will typically be some restriction on ability to pay dividends on shares or make other payments triggered by such a suspension. Restrictions on ability to suspend distributions could take the form of requiring that payments must be made if current profits exceed (perhaps by some multiple) the contractual distribution amount (unless a breach of the capital conservation buffer prevents that). For mutuals, who do not pay dividends on ordinary shares, there would need to be other resulting restrictions. These could include: restrictions on payments of staff bonuses, restrictions on board remuneration.

- **Maturity.** AT1 securities are required to be perpetual, although a mandatory conversion date (subject to certain conditions being met) is permitted, as is an issuer call option after some specified period (with exercise conditional on APRA approval). For T2 securities, initial maturity of at least five years is required and pro-rata inclusion of the principal amount applies based on residual maturity of less than five years.

Implications for Mutuals

The most obvious form of possible external capital instrument for mutual ADIs is some form of preference share which has the ability to pay franked dividends. Such preference shares can be perpetual or potentially callable (but not convertible into ordinary shares), or in principle could have a defined finite maturity. There is no strong argument to support requirement for a conversion into some untested and vague “Mutual Equity Interest” as proposed by APRA.

Whether a write-down component for such instruments (to make compliant with Basel requirements) is really required is problematic. By itself, a write-down simply changes the composition of regulatory capital (the decline in book value of the AT1 or Tier 2 instruments is matched by an increase in the book value of CET1 capital). It is the consequences which then follow which are significant. The Basel approach implies that the ADI would then have to raise new capital to replace that converted or written-down, but the ability to do so at that time is surely compromised by the bail-in having just occurred. Indeed, it is quite likely that a “run” on the ADI by uninsured creditors (large depositors, debt holders, financial institution counterparties) could be expected. Because of this, the bail-in provisions are better seen as providing scope for the regulator to achieve a smooth exit of the ADI – most likely via merger with a stronger institution involving a transfer of assets and liabilities. While a write-down of some liabilities (the AT1 or T2 capital) might facilitate such a merger (by reducing liabilities

relative to assets transferred) the fact that the ADI is still in a position of positive net worth when the trigger event occurs reduces the strength of such an argument for write-downs. The merger would reduce the capital ratio of the acquirer, but in general it could be expected that potential acquirers would have surplus capital and would be in a position of strength enabling them to restore their capital position to their desired level in due course.

Potential Investors

Australian regulators appear to have been reluctant to let mutual ADIs offer preference share instruments to their members.⁷ One explanation for this is the bad experiences for retail investors associated with failures such as Pyramid Building Society and various finance companies. Investors with Pyramid were often not aware that they had not invested their funds in deposits, but rather in preference shares – which had lower ranking in the case of insolvency (and were not protected by any State-based compensation fund). In the case of finance companies, the investments were debentures, and investors were (arguably) not aware that these were not the same as deposits and that finance companies were not subject to the same prudential regulation as ADIs. The higher promised return offered on such investments was not adequately perceived as reflecting a higher level of risk.

Arguably, those profit oriented institutions found some benefits to their owners or managers in taking investor funds in forms which involved higher risk than appreciated by the investors – and for which promised returns did not offer adequate compensation. In principle, at least, this should not be the case where mutual ADIs are concerned – where the objective of providing member value should remove incentives to miss-sell investment products to members. While boards or executive management could make decisions aimed at benefiting one group of members at the expense of others, disincentives to do so can be built into the consequences arising from miss-selling of products. Limitations on allowable remuneration practices and incentive structures for staff providing staff or in a “sales” function can reinforce that.

In a world where the Financial Claims Scheme (FCS) exists – which did not apply at previous times, the case for prohibiting issues of preference shares to members is significantly weakened. Such securities would not qualify for the deposit insurance protection provided by the FCS. Consequently, there is a clear distinction possible between such securities and deposits. Marketing materials and prospectuses can be required to make

⁷ Several did so in 2006 but were apparently prevented from making further issues by the regulators. The Basel 3 capital definitions currently make it difficult if not impossible for making issues of simple preference share which can serve as regulatory capital.

such distinction prominent. Whether all members of the credit union will understand and appreciate the distinction, is another matter. But subject to adequate disclosure and information provision requirements, and incentives and requirements for providers of products to ensure investor suitability this should not prevent mutuals from offering such products. In particular, if there are publicised write-down conditions, these should signal to member-investors that these are markedly different from deposits.

Mutual institutions such as credit unions were established on principles of self help and communal involvement which meant that members had information advantages which could help the success of the organisation – including governance and decision-making. That has largely disappeared, but by enabling members to invest in potentially risky capital securities issued by mutuals, and sell those to others (members or non-members) the market price of such securities can provide valuable information about institutional soundness and provide market discipline. Indeed, one of the arguments often advanced about possible weaknesses of the mutual form is the absence of capital market discipline. Allowing mutuals to issue securities which are tradeable, such that market prices convey information about the issue strength, rectifies (at least partially) this possible weakness of the mutual form.

For small mutual institutions, issuing securities which can be traded amongst investors requires the establishment of some form of secondary market. In principle, such an “exempt” market can be operated by the institution itself – and modern technology makes that a cost-effective possibility. Regulatory requirement for market operators need to recognise the merits of such activities – and approval of creation of securities markets is another area where regulators have been extremely (and arguably over-) cautious. Moreover, because the securities traded do not involve ownership/voting rights, there are less regulatory concerns that where ownership rights are involved.

The ability of mutual ADIs to tap investor markets for regulatory capital is limited by relatively small scale. Consequently there are merits in allowing the use of “pooled trust” structures. In such structures, participating institutions issue preference shares with specified terms to a special purpose vehicle which in turn issues securities, indicating a claim on the pooled assets, to institutional investors. These have been used by Australian credit unions and by depository institutions in other jurisdictions but appear to be effectively precluded by the Basel 3 requirements for regulatory capital to have bail-in provisions. There is, however, no obvious impediment to using such a structure where only a write-down provision is in place. Write-down of preference shares, or suspension of dividends, of one troubled institution will flow through to the value of securities issued to investors by the pooled trust/SPV, without

any direct implications for other participating mutuals. However, the adverse indirect effects of association (via the trust) with the troubled institution should induce greater monitoring of performance of participating mutuals by other participants in the trust.

Conclusions and Recommendations

1. The Basel 3 “bail-in” requirements create significant complexities for mutual ADIs in the design of securities meeting eligibility requirements for regulatory capital. The merits of having such bail-in requirements are generally unclear, and APRA should revisit its support of the Basel requirements in this regard. It is unclear why the issue of perpetual or fixed maturity, tradeable, preference shares (or indeed other forms) would not be appropriate as a form of regulatory capital for mutuals.
2. Mutuals should be permitted to attach franking credits to such regulatory capital instruments – similar to the situation for “joint-stock” ADIs. This would be preferable to introducing special tax arrangements for mutuals to offset their inability to issue securities to which franking credits can be attached.
3. If bail-in is to apply for mutuals, the only feasible approach is for a “write-down” provision rather than a “conversion into equity” provision to be used. The APRA suggestion of “Mutual Equity Instruments” arising from a conversion appear impractical.
4. There is a case for limiting the maximum value of capital instruments allowed to be issued to be some proportion of core capital. An objective of this provision would be to ensure that, in general, the mutual will have sufficient (pre-distribution) surplus to be able to meet contractual distribution payments and continue to accumulate core capital via retention of earnings.
5. Write-down provisions, if required, will need to involve clear identification of conditions under which write-down can occur and consequences for subsequent financial decisions of the mutual – including restrictions on payments to board and management. It is not obvious that such write-downs should be permanent rather than reversible if the mutual ADI returns to financial health – although write-downs are likely to, in turn, trigger an exit of the firm from the industry.
6. Acceptable capital instruments should have provisions which enable to non-payment of distributions on those securities – subject to specific limitations. For example, non-payment could be required (or permitted) if contractual distributions exceeded annual

profits (or some proportion thereof). While the Basel requirements are that distributions are non-cumulative, the logic of such a prohibition rather than allowing payment of cumulated obligations under certain specified circumstances – such as a return to strong financial health – is not obvious.

7. Issuance of regulatory capital instruments to members should be permitted. The nature of mutual ADI objectives (of serving the best interests of their members) is such that miss-selling of such instruments to members should not occur – and remuneration and accountability arrangements can reinforce this. The potential for members to not understand the difference between deposits and such instruments is reduced by the exclusion of coverage by the FCS for such instruments – which would need to be well documented and publicised.
8. Allowing tradeability of such instruments provides an element of market discipline via the price movements of such instruments. Regulators should encourage the ability of mutual ADIs to offer secondary markets in such instruments.
9. Impediments to mutual ADIs raising capital via structures such as “pooled trusts” should be removed.

Appendix

Taxation of mutual ADIs has experienced a number of changes over the decades. When company tax was initially applied to surpluses of mutual credit unions in 1958, it encouraged a shift from accepting funds from members in the form of “shares” towards deposits. (Interest on the latter was a deductible expense whereas payment of dividends to members was not). This was a fundamental change in the mutual nature of credit unions, making them more akin to banks in the form of deposit takers, rather than a mutual fund type of organisation. While company tax was subsequently largely removed in 1974 (changes made meant that income from members was not subject to taxation), the shift to a deposit taking institution format was entrenched.

Company tax was reinstated in 1994, paradoxically at a time when the dividend imputation tax system was well established. It is paradoxical in the sense that imputation means that company tax is “washed out” when companies distribute profits as dividends with accompanying tax credits to Australian owners. In that regard, applying company tax to mutual institutions which are unable to distribute franking credit to owners “locks up” the valuable tax credits within the institution. Whether that is disadvantageous to mutuals or not, in terms of the overall tax rate (company plus personal tax) applied to their activities, depends on the average marginal tax rate of the members who would otherwise be the recipients of dividends. It has been estimated that the average tax rate of credit union members is probably somewhat below the company tax rate, meaning that there is some, but probably not a large, resulting competitive disadvantage from this tax effect.⁸

There is, however, a clear effect on the ability of mutual ADIs to accumulate capital. The application of the company tax rate of 30 per cent means that only 70 per cent of before tax tax profits are available to be retained in the institution. This reduces the ability of the mutual to increase its capital base. Moreover, because credit unions are generally unable to distribute the tax credits, they are prevented from accessing potentially cheaper capital funding from members or other investors who would value such tax credits being attached to distributions on their investments.

There have been a number of proposals over the years aimed at rectifying this anomaly. One is to remove the application of company tax to mutual ADIs. That is a step too far since it would tilt the playing field in the opposite direction. An alternative is to apply a modified

⁸ For discussion see Kevin Davis “What is “Fair” Taxation of Credit Unions?” ACFS FRDP – 2010-06 December 2, 2010 <http://australiancentre.com.au/wp-content/uploads/2016/04/FRDP-021210-1.pdf> and ACFS “Equitable Taxation of Customer Owned Banking” [Attachment B of COBA submission to FSI](#)

company tax rate to mutual profits but not create franking credits from the tax paid. In principle, the modified tax rate could be designed such that there would be a level playing field with a hypothetical, otherwise similar, joint-stock ADI which distributed all of its annual profits with tax credits to shareholders. If those investors are on an average tax rate of “t”, the appropriate modified company tax rate to ensure tax parity would also be “t”.⁹

Estimating the average tax rate which would be paid by shareholders in this hypothetical joint-stock ADI is problematic, but the average tax rate of the mutual’s depositors is possibly in the order of 20 per cent. If it were to be noted that the hypothetical ADI might have many superannuation investors on significantly lower tax rates, the average tax rate could be significantly lower. While it is true that most banks have a range of investors including international investors who do not value franking credits, it can be argued that the appropriate comparison here is with a hypothetical Australian operating and owned ADI.

An alternative comparison might be made with the newly emerging P2P (or “marketplace lending” institutions. For such institutions, while there will be company tax paid on their profits, the amount involved can be expected to be much smaller for a given level of lending than for ADIs. The reason is that these platform lenders do not require a prudential capital base to provide a buffer of protection to investors who are bearing the credit risk on the portfolio of loans. (Their profits are thus the return on capital invested in developing the operating platform etc., and not on the capital which helps fund the loan portfolio). To the extent that their investor base has a lower tax rate than the company tax rate, the amount of tax paid on this form of “intermediation” will be lower.

(As a digression, it could be argued that P2P lenders have similarity with mutual financial institutions as they were originally fashioned. Members of a mutual would contribute money/savings by way of an investment in withdrawable shares, with that money pooled to make loans to other members. Those contributing funds had an exposure to defaults on the portfolio of loans of the mutual, just as P2P investors have an exposure to the portfolio of loans in which they invest. In that original formulation, where funds were “shares” rather than “deposits”, a capital base for prudential reasons was unnecessary).

⁹ To see this, assume: Assets = A, Deposits = D and Equity = E, and r_A is interest rate on assets, r_D is interest rate on deposits, and for simplicity (but without loss of generality) that there are no operating costs. For the joint stock company which pays all profits as franked dividends to Australian shareholders on an average tax of “t”, total tax paid on its activities will be $r_A A t$. For equivalent tax to be paid by the mutual, where profits are retained and no franking credits created, a modified company tax rate of t_m would lead to total tax of $r_D D t + t_m (r_A A - r_D D)$. Setting this equal to total tax paid on the joint-stock ADI’s activities leads to the result $t_m = t$.

Those comparisons suggest that one way to overcome a perceived unfairness in the tax treatment of mutual ADIs would be to adopt a modified company tax rate for them, but is based on the assumption that there is no facility to the mutuals to distribute earnings and attach tax credits. That implicitly assumes that they are unable to raise external capital – and changing that constraint is likely to be a better alternative.

Another option suggested has been to enable the attachment of tax credits to interest paid on deposits. That would likely create distortions in relation to other entities.

This Financial Policy Brief was prepared by Professor Kevin Davis, Research Director of the Australian Centre for Financial Studies

About the Australian Centre for Financial Studies

The Australian Centre for Financial Studies (ACFS) is a public interest research centre within the Monash Business School.

It aims to facilitate industry-relevant, rigorous research and independent commentary, drawing on expertise from academia, industry and government to promote thought leadership in the financial sector.

Together, ACFS and Monash Business School aim to boost the global credentials of Australia's finance industry, bridging the gap between research and industry and supporting Australia as an international centre for finance practice, research and education.

For further information see: www.australiancentre.com.au | business.monash.edu

About the Australian Centre for Financial Studies Policy Briefs

ACFS Financial Policy Briefs (previously called Financial Regulation Discussion Papers) provide independent analysis and commentary on current issues in financial regulation with the objective of promoting constructive dialogue among academics, industry practitioners, policymakers and regulators and contributing to excellence in Australian financial system regulation.

For more in this series, visit: <http://australiancentre.com.au/publications/policy-briefs/>