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Can Mutual Banks profit from the Royal Commission?

Financial Policy Brief

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MONASH BUSINESS SCHOOL

Thought Leadership in the Financial Sector

FINANCIAL POLICY BRIEF

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In this ACFS Financial Policy Brief, Professor Kevin Davis considers whether mutual banks and ADIs can take advantage of the reputational damage to larger banks to attract customers, grow their market share, and increase competition in the market for retail financial customers. He concludes that regulatory minimum capital requirements which are not suited for, but applied to, mutuals will prevent such an outcome. This is despite recent approval to issue Mutual Equity Interests as a form of regulatory capital, because the cost to members of such issues will likely exceed the benefits.

He argues that radical changes are needed to get around the capital requirement roadblock. He recommends that mutuals should consider, and legislators and regulators facilitate, the creation of new investment products for financing customer loans similar to P2P/marketplace lending. Investors in "loan fund units" offered by the mutual would have a direct interest in a portfolio of loans, giving a higher expected return than deposits, but would face a risk of loss of part of their investments if borrower performance was poor. This type of intermediation should not attract (significant) capital requirements, and is consistent with the original communal self-help ethos of mutuals whereby members with surplus funds made them available to those currently seeking funds.

Over recent decades, mutual financial ADIs (credit unions, building societies, mutual banks) have struggled to maintain their market share (currently at around 2.5 per cent of total ADI assets) against the "for-profit" larger banks. With the fall-out of the Royal Commission tarnishing the reputations of the larger banks, an obvious question is whether their smaller not-for-profit competitors can attract disgruntled bank customers and grow market share?

Noticeably, the mutuals did not incur the opprobrium of the Royal Commission – the very few references to them were, if anything, complimentary. And the many references to the potential adverse consequences for customers of organisational cultures and governance structures built on profit seeking must have been music to the ears of the mutual, not-for profit, sector.

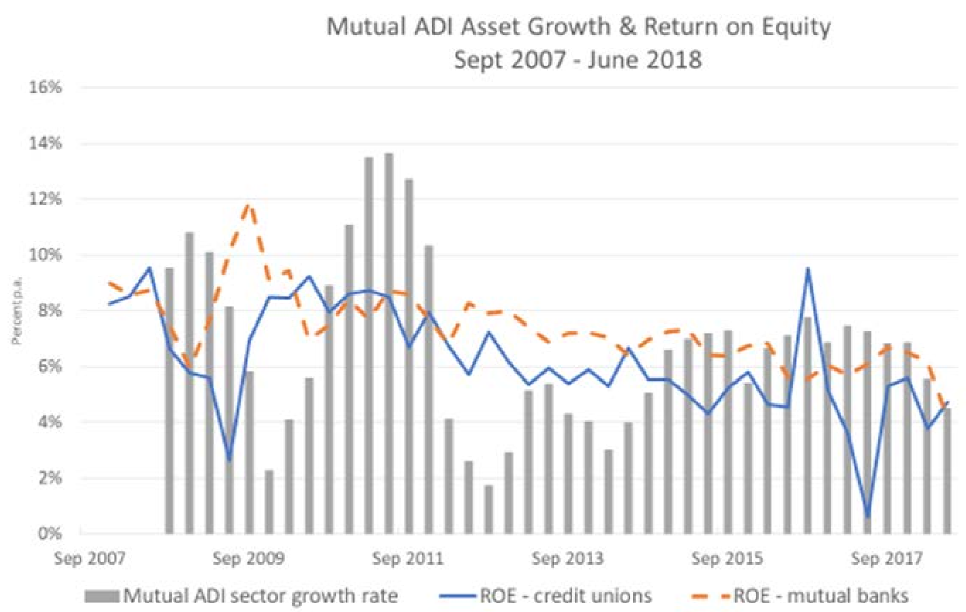
Unfortunately, the likelihood of the mutuals being able to turn the discomfort of the for-profit banking sector to their advantage is low. The slow growth rate of the sector o the last decade is likely to continue, unless some unlikely, radical, policy changes are introduced by the Government.

The figure below shows that the annual growth in mutual ADI total assets over the last decade has averaged around 6 per cent, which is well below that of the other banks, and barely enough to keep pace with nominal GDP growth. (The higher growth after the global financial crisis is probably partly explained by the introduction of the Financial Claims Scheme (FCS) leading some customers to no longer view deposits in small mutuals as being more risky than those in large banks. Unfortunately for the mutuals, and partly reflecting inadequate marketing on their part, many individuals are not really aware that deposits in mutuals are covered by the FCS in the same way as for banks).

The figure also shows that profitability of the mutuals, as measured by their return on equity (ROE) has also been around the 6 per cent p.a. mark, well below the double-digit rates of the major banks.

And that is the crux of the problem facing the mutuals.

Figure 1: Mutual ADI Asset Growth & Return on Equity



Source : APRA (Pre 2011, mutual bank figures are for building societies)

Like the other banks, the mutuals are required by APRA to meet minimum regulatory capital requirements. Unlike their for-profit competitors, they have (until recently) been generally unable to raise additional capital from equity issues, instead having to rely on accumulating capital from retention of profits. A ROE of around 6 per cent means that capital also grows at around 6 per cent (since all profits are retained). If the mutual grows its deposits and assets above that rate, its capital ratio will fall, incurring APRA's displeasure and ultimately its wrath if a high growth rate causes the capital ratio to fall too close to the regulatory minimum.

So, how could the mutual ADIs take advantage of the Royal Commission fall-out to rapidly grow their business size without running into the capital adequacy roadblock?

One option which has recently opened up is their new ability to issue Mutual Equity Interests (MEIs) to investors. The funds raised from issue of these preference share type instruments can be counted as regulatory capital, enabling faster growth without a lowering of the mutual's regulatory capital ratio. And because MEI distributions can incorporate franking credits, that overcomes one of the problems the mutuals have faced – that of generating franking credits but not being able to distribute them to members who can use them.

That all sounds promising. Unfortunately, however, investors will demand a market-related yield to be paid on these securities. And it makes no sense for a mutual to issue MEIs if the yield required by investors exceeds the rate of return the mutual can earn on the capital provided.

Is that the case? Yes, for most mutuals. The yields paid by the major banks on their recent preference share issues provide a benchmark for determining the likely required return of potential investors in MEIs. Allowing for a mutual's MEI issue being smaller in scale, and probably perceived as being more risky and less liquid, a yield of somewhat above 6 per cent (with franking credits attached) would likely be needed. But with most of the mutuals earning 6 per cent ROE or less, it would not be to the benefit of members for them to issue such MEIs.

The alternative for the mutuals is to adopt a strategy of targeting a higher ROE, enabling them to grow capital internally at a faster rate, and also making issue of MEIs potentially feasible. But that also involves significant problems and is not value adding for the members of the mutual for the following reason.

For a mutual to increase its ROE, it has to make greater profits from its dealings with its customers (who are also its owner/members). One way that can be done is by increasing loan rates and decreasing deposit rates (ie increasing its net interest margin) or increasing various fees. That is hardly to the benefit of its member/customers! It would also work against the objective of attracting disgruntled bank customers!

Another way is to find operating economies by lowering cost structures. It is generally argued (for example by the Productivity Commission in its recent review of financial sector competition) that mutuals are less efficient than the larger banks. That is consistent with them being competitive on pricing but having a lower ROE due to higher costs.

But whether mutual ADIs can find cost savings without reducing services to members is open to question. The higher costs may not reflect inefficiency per se, but may be more a reflection of smaller scale of operations. If so, mergers may help – but any significant cost savings are likely to take several years to eventuate, which is of no help in responding to the shorter term competitive opportunity afforded by the Royal Commission.

So what, if anything, can be done? The solution must involve some changes which mean that regulatory capital requirements are no longer an impediment to growth. Those requirements are the Achilles' heel of the mutual sector – and basically inconsistent with the notion of mutuality. They are premised on some separate group of stakeholders (the owner shareholders) providing a buffer of capital to absorb, and protect depositors against, losses. But for mutuals, there is no distinction between owners and depositors (all customers are also the owners).

Prudential regulators, such as APRA, have applied capital requirements designed for for-profit banks to mutual ADIs without taking account of the different organisational structure.

An argument can be made for mutuals having some capital accumulated over time from profits, such that any losses impact upon that collectively owned pool of wealth, rather than individual depositor accounts. A decline in the communally owned capital due to operating losses would have very different effect on member psychology and behaviour than if the loss was charged against deposits of members.

But, the question of whether this approach for protecting depositors is the best one needs to be considered carefully. Are there some alternatives?

At least two radical alternatives spring to mind. One would be to allow mutuals to operate with much lower capital ratios than for-profit entities, and instead provide protection for depositors by requiring compulsory purchase of deposit insurance from a government agency by low-capitalised mutuals. While the annual cost of such insurance to the mutual may limit the attractiveness of such an approach, it may well be that it would be less of a constraint to growth than having to maintain a high capital ratio.

A second radical alternative would be for mutuals to issue different, or additional, types of claims to deposits. Peer to peer (P2P), or marketplace, lenders have shown how savers can make investments on which the return depends upon the repayments from the portfolio of loans funded from those investments. Better returns than from traditional deposits are expected, but there is also the risk of loss of some part of the investment, particularly if loans are not carefully screened and investments not sufficiently diversified across many loans.

Why should mutual ADIs not offer similar investment products (which would not be protected by the FCS) in addition to traditional deposits? Some are, indeed, making investments of surplus funds via marketplace lenders, but that is different to offering such opportunities directly to members. Moreover, those investments do not escape the regulatory capital requirements since it is the mutual ADI which is bearing the risk of loss.

If allowed by regulators, mutuals could provide a new form of investment opportunity for member savers which could be called, for example, "loan fund units". Those investments could be used solely to fund a particular set of loans to other members (as is the P2P model). The return on loan fund units would be linked directly to the performance of those loans.

This would have no adverse implications for the safety of deposits. There would be two separate pools of assets, one funded by deposits and the other funded via P2P style investments. The loan fund units would have a higher expected return than deposit interest rates, but involve risk of loss and not be covered by the financial claims scheme. Liquidity (the ability to withdraw funds early) would also be limited – although creation of a secondary market in which the units could be sold is feasible.

Because the mutual ADI itself is not exposed to risk of loss on loans funded by loan fund units, there need be no significant capital requirements for credit risk associated with this form of lending. Some, much lower, capital requirement for operational risk would be likely to apply.

Introduction of such an alternative to deposit financing of loans has similarities with the original philosophy of mutuals. That was based on a communal "self-help" model in which those members with surplus funds made them available to those needing funds and faced the resulting risks from this.

Currently mutual ADIs appear effectively precluded from adopting such an approach because legislation precludes them from raising funds which are secured against assets of the ADI. But that restriction is designed to protect depositors from the risk of there being other secured creditors having higher priority claims on the asset pool funded by them both. With loan fund units, a separate pool of assets is involved.

A change in legislation would likely be required to permit mutual ADIs to directly offer a P2P option to those of their current and prospective members who are willing to take a somewhat higher risk (and less liquid) investment in return for a higher expected return. Alternatively, APRA would need to grant approval to mutuals to establish subsidiary companies which operated such a P2P platform.

By facilitating an increased source of funding for the making of loans, mutual ADIs would be able to provide increased competition to banks in the loan market.

Without some radical change such as this, the opportunity provided by the Royal Commission for the mutual sector to inject greater competition into “banking” will be lost.

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

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