



FINANCIAL REGULATION DISCUSSION PAPER SERIES

Mutual Equity Interests – An Oxymoron?

FRDP 2013 – 3

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In this ACFS Financial Regulation Discussion Paper, ACFS Research Director Professor Kevin Davis examines the recent proposal by APRA to allow mutual ADIs to issue contingent capital instruments which would convert, under certain circumstances, into a new equity type claim on the mutual called a Mutual Equity Interest (MEI). Although the proposal is based on aiming for a level playing field between mutual ADIs and banks in issuing contingent capital, it makes the implicit, unsubstantiated, assumption that contingent capital is preferable to designing or facilitating issuance of some other form of equity capital by mutuals. As well as involving a number of unresolved design issues MEIs would create new, problematic, governance problems for mutual ADIs.

APRA's recent release of draft revisions¹ to APS 111 (Capital Adequacy: Measurement of Capital)² envisages the creation of a new financial instrument "mutual equity interests" (hereafter MEIs). These would be a liability of mutual ADIs arising from the forced conversion of previously issued debt or hybrid securities triggered either by the ADI's capital falling below a specified level or by a decision by APRA that there was a risk of non-viability. The rationale for including provisions allowing for forced conversion when such securities are issued is that, as a form of contingent capital, they are then able to be counted as regulatory capital.

The objective is admirable – to achieve a level playing field such that mutual ADIs would, like banks, be able to issue contingent capital securities which could count as regulatory capital. For mutual

¹ <http://www.apra.gov.au/adi/PrudentialFramework/Pages/Letter-to-mutually-owned-ADIs-mutual-equity-interests.aspx>

² [http://www.apra.gov.au/adi/PrudentialFramework/Documents/Basel-III-Prudential-Standard-APS-111-\(January-2013\).pdf](http://www.apra.gov.au/adi/PrudentialFramework/Documents/Basel-III-Prudential-Standard-APS-111-(January-2013).pdf)



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ADIs this is potentially appealing, because very limited access to external sources of capital means that growth in capital (and thus balance sheet growth) is otherwise constrained by return on equity.³

But the concept of a mutual equity interest is, essentially, an oxymoron. MEIs create a new group of (non-voting) owners of the mutual with different objectives from the existing owner-members, including gaining private benefits from profit maximisation and resulting cash distributions on MEIs. Managers of the mutual ADI would then face a difficult governance problem of reconciling these conflicting interests. MEI holders could also have incentives to encourage demutualisation or liquidation of the ADI.

Indeed, discussion of contingent capital instruments which convert into, not yet well defined, MEIs is putting the cart before the horse. It would seem more appropriate to first debate the question of whether mutuals should be able to issue some other form of specifically structured equity capital instrument, rather than non-equity securities which might convert into some form of equity interest. In Norway, for example, cooperative banks can issue equity certificates which have limited voting rights and claims on the capital of the bank. In the UK a *Mutuals' Redeemable Shares Bill* was introduced into Parliament in July 2013.⁴

Contingent Capital Requirements for Banks

Contingent capital securities have already been issued by Australian banks (generally as preference shares), and include conditions that mandatory conversion into ordinary shares (or write off) occurs if certain trigger conditions related to risk of non-viability of the institution are met. A brief summary of these conversion conditions is contained in Box 1.

³ If a mutual ADI is to keep its (non-risk-weighted) capital ratio constant, inability to access external capital means that the growth rate of total assets cannot exceed its return on equity.

⁴ <http://www.mutuo.co.uk/wp-content/uploads/2013/11/Raising-New-Capital-in-Mutuals.pdf>



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Box 1: Contingent Capital Conditions of APS 111

Certain non-equity highly subordinated securities issued by ADIs can be counted as additional Tier 1 regulatory capital if they (in addition to other requirements):

- provide for automatic conversion into listed equities of the ADI or its parent (or write off) if the common equity Tier 1 ratio falls below 5.125 per cent of risk-weighted assets¹
- the conversion arrangements must provide that holders of the securities receive equities of lesser value than the original issue price if the share price has fallen to less than 20 per cent of its value at the original issue date.
- the securities are perpetual, but the ADI is able under some circumstances to call the securities and must have flexibility to suspend cash distributions on the securities
- provide for conversion or write off if APRA determines that the ADI is at risk of non-viability.

Certain non-perpetual securities with remaining maturities greater than five years can be counted fully as Tier 2 regulatory capital if they provide for conversion or write off if APRA determines a risk of non-viability.

The mutual dilemma regarding Contingent Capital

The difficulty with proposing contingent capital issues for mutual ADIs is that they do not have tradeable, ordinary shares into which such conversion could occur.⁵ Each member-owner-customer owns one non-tradeable share of nominal value (eg \$1). Consequently the equity base of such

⁵ For this reason, contingent capital issued by Rabobank (a cooperative bank) involves only the option of write-down and not conversion into equity.



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institutions is almost entirely their accumulated retained earnings – which is communally owned, but not accessible to individual member-owners except in the event of demutualisation or wind-up.

The concept of MEIs is a new one, which appears untried elsewhere in the world⁶ and its characteristics are not fully developed in the APRA proposals.⁷ Consequently it is important to understand how contingent capital which might convert into MEIs might be designed and the effects on the operations of mutual ADIs. There are three features which need attention. The first is the nature of a MEI and how its existence (arising from a mandatory conversion of contingent capital) would affect the subsequent operation of a mutual ADI. Second, how might the conversion arrangements best be designed? Third, how would the issue of contingent capital securities, which might at some date be converted into MEIs, affect the operation of a mutual ADI?

Before considering these questions, it is appropriate to provide an overview of the APRA proposals.

The APRA Proposals

APRA envisages a *MEI* as an equity style claim on a mutual ADI, which differs from ordinary shares in a joint-stock company, such as a bank, in several important ways.

One is that dividends payable to MEI holders will be capped at some level. APRA proposes that such distributions can only take the form of cash and cannot exceed 50 per cent of after tax profit for that period. There is no discussion of whether the distributions could be franked (although the requirement that distributions are only in cash may preclude that) nor how the level of distribution should be determined (or why 50 per cent is an appropriate upper bound on distributions).

⁶ UK Treasury (2012) considers a number of forms of capital raisings (actual and proposed) by mutuals in the UK and Europe including Contingent Convertible Notes which may convert into Profit Participating Deferred Shares – which have some characteristics similar to MEIs.

⁷ There does exist in various State legislations a concept known as Cooperative Capital Units being “an interest issued by a co-operative conferring an interest in the capital, but not the share capital, of the co-operative” (Limnios et al, 2012) enabling capital raising flexibility for cooperatives. Whether such legislation could provide a framework for legal specification of characteristics of MEIs is open to question.



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The second is that in the event of liquidation of a failed mutual ADI, the maximum amount of any surplus available for distribution available to MEI holders would be capped at the nominal value of the original securities prior to conversion. This latter requirement seems largely irrelevant, unless liquidation of a failed institution involves forced closure by APRA even if it has positive equity (but perhaps less than the minimum regulatory requirement). In that case, there would need to be some process for determining the allocation of remaining wealth between member owners and the holders of MEIs. In the more likely liquidation event of a “true” failure, where assets are worth less than the value of deposits and other non-equity liabilities, depositor preference and subordination of MEIs would mean that MEI holders receive nothing.

MEIs can incorporate an issuer redemption option subject to conditions which include APRA approval and issuer discretion as to timing of exercise, but subject to a requirement that the redemption value does not exceed the nominal value of the original securities from which MEIs have been derived. This is clearly necessary to facilitate the possible merger of a mutual with MEIs on issue with another mutual.

APRA also requires that MEIs have no voting rights thus preventing holders directly influencing the operations of the mutual. In practice, however, MEI holders could become voting member-owners for a nominal cost and via coordinated action in that capacity influence the operations of the mutual.⁸ This could be particularly relevant should the mutual ADI return to a sound financial position with a substantial equity base and be a candidate for privatisation of that wealth via demutualisation. Holders of MEIs may also have incentives to encourage liquidation, enabling them to recoup their principal earlier than might otherwise occur (if at all).

APRA’s draft amendments include two types of trigger point. One is for inclusion of the issued security as Additional Tier 1 capital when the Common equity Tier 1 risk weighted capital ratio falls below 5.125 per cent. A non-viability trigger must also be included for instruments to be eligible for inclusion as Additional Tier 1 or Tier 2 regulatory capital. (Additional Tier 1 instruments are required to be perpetual (although redemption by the issuer is permitted in some circumstances) while Tier 2

⁸ At one time common bond membership provisions of credit unions might have proved an impediment to this course of action, but rarely have any relevance nowadays.



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contingent capital instruments can have a fixed maturity – although only if the remaining maturity is greater than five years will they count fully as regulatory capital).

Box 2: APRA’s conversion requirements for contingent capital of Mutuals

“For mutually owned ADIs, where an Additional Tier 1 Capital instrument provides for conversion into mutual equity interests when the loss absorption trigger point is breached, the issue documentation must:

- (a) specify the number of mutual equity interests to be received upon conversion, or specify the conversion formula for determining the number of mutual equity interests received;
- (b) provide for the number of mutual equity interests to be received under the formula specified in (a) to be fixed; and
- (c) set the maximum number of mutual equity interests received such that the aggregate value of the interests received cannot exceed, at the date of conversion, the nominal value of the additional Tier 1 Capital instrument converted.”

One consequence of MEI creation is that the holders are likely to face a loss of value of their investment – although this depends on the precise nature of the conversion arrangements. Loss of value arises because the value of MEIs received cannot exceed the nominal value of the securities converted, and cash distributions are restricted.

MEI's and ADI operations

A mutual ADI which has MEIs in existence will face challenging governance issues. While holders of MEIs rank equally with other member-owners, they can be paid a dividend out of the mutual's profits, whereas the other owners cannot. They have an incentive to encourage management to maximise profit since they gain from higher profits (and consequent cash distributions). They may also benefit from higher risk taking due to the asymmetry of potential returns (limited downside and unlimited upside). By also becoming member-owners, MEI holders may be able to establish a



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sufficiently large voting bloc to influence or control the management of the mutual ADI. These objectives of profit maximisation and risk-taking are inconsistent with the objectives of the member-owners. Higher profit (such as arising from higher loan interest rates and lower deposit interest rates) is at the expense of member-owners in their transactions with the mutual ADI, while member-owners have no private claim on greater wealth from increased risk taking and can suffer losses on deposits from any resulting losses. While many mutuals have profit targets in order to accumulate capital from retained earnings, this is not the same as profit maximisation, and involves balancing benefits to current members with benefits from growth.

While APRA is silent on the matter, it could be assumed that MEIs will be tradeable securities, giving holders the option to exit their investment via secondary market sales. Market prices for MEIs thus introduce a new form of capital market discipline for mutual ADIs, and require management to balance conflicting objectives of achieving some target market price for MEIs with maximising benefits to owner-members. Paradoxically, a common form of market discipline, acquisition of shares of underperforming companies to gain control, does not operate in the case of MEIs. Holders of MEIs can only acquire voting rights by becoming ordinary member-owners. One vote per member means that as holdings of MEIs become more concentrated in fewer holders, the size of their associated voting power declines.

It is possible that holders of MEIs will have incentives to push for demutualisation or liquidation of the credit union. Market values of MEIs may be less than the amount which would be received in the event of those changes, reflecting the likely absence of cash distributions in the near term⁹ arising from the Basel 3 "Capital Conservation" buffer. This precludes distributions if the Common Equity Tier 1 ratio is below 7 per cent – which is likely to be the case unless the amount of MEIs created is very substantial. Even then, managerial concerns (and APRA pressure) to rebuild capital is likely to prevent dividend payments for some time.

⁹ For this reason, forced conversion of contingent capital also implies a potentially significant period of no cash distributions for banks as well.



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Conversion arrangements.

One complexity in designing contingent capital for a mutual ADI is that there is no market based measure of the value of the equity of the ADI on which a conversion ratio can be based.¹⁰ APRA specifies that the value of MEIs created by conversion must not exceed the pre-conversion nominal value of the original securities. This appears to be a condition applying to the resulting book value of MEIs. Indeed, it would appear impossible *ex ante* to enforce such a condition applying to the market value of MEIs.

It is not clear whether the conversion constraint refers to the original nominal value of the securities issued, or their market value (assuming that they are traded) immediately prior to the forced conversion. If the latter, it could be anticipated that a "death spiral" for the price of those securities could eventuate, as holders attempt to avoid the loss upon conversion by prior sale of the securities. The resulting declining market value would then dilute the maximum share of MEIs of the mutual equity base. This could be more severe than might occur in the case of an ADI with listed equities. There the institution's problems would be likely to be reflected in a declining equity price, such that conversion arrangements linked to equity prices (such that the value of shares received remains constant for example) would be less likely to have such a diluting effect.¹¹

If the conversion constraint relates to the original issue value of the contingent capital securities, the pre-conversion price dynamics are less clear. The potential value of the MEI's claim on capital of the mutual would reduce downward pressure on the market price of the contingent capital. While it is not explicit in the APRA proposals regarding mutuals, the conversion requirements currently in APS 111 relate to the initial issue price of the contingent capital securities.

In designing the conversion arrangements, an important consideration is the incentives it provides to mutual ADI management prior to potential conversion. Arguably, stronger managerial incentives to limit risk taking exist if the cost to existing owner-members from the conversion arrangements is

¹⁰ This is also a problem for banks whose shares are not traded on an exchange. However, such shares can still generally be sold, can have dividends paid on them, and provide a pro rata private claim on the net wealth of the institution.

¹¹ APRA's requirement that, when the equity price has fallen below 20 per cent of its value at the initial issue date of the contingent capital value, conversion involves a reduction in market value for holders limits the extent to which this can hold.



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higher. Using the initial issue value of the contingent capital securities rather than the pre-conversion market value to determine MEI value received would be more consistent with this. At the same time, imposing lower conversion costs on holders of contingent capital reduces their monitoring incentives but may not increase monitoring by depositor-owners (who are largely protected from loss by the Financial Claims Scheme).

Mutual ADI operations when contingent capital is on issue

The ability to issue contingent capital relaxes somewhat the constraint on mutual ADI growth imposed by the need to acquire additional capital internally by making profits rather than external capital raisings. However, as noted earlier, a prior debate is warranted on whether mutuals should be allowed to issue other forms of equity which would count as regulatory capital, rather than introducing contingent capital which might convert into some other form of equity.

Currently most mutual ADIs are well capitalised (relative to banks), but one consequence of high capital ratios is that they tend to reduce the achievable return on equity which, for mutuals, provides the natural limit on balance sheet growth if capital ratios are not to decline. Consequently, it might be expected that likely issuers of contingent capital will be those mutuals with high capital ratios (which they are unwilling to see decline) with significant growth prospects. While initially high capital ratios might make the cost of contingent capital relatively low (due to low probability of forced conversion), making faster growth worthwhile, ultimately mutual managers will need to balance the benefits and costs of faster growth, internal capital generation, and use of contingent capital.

Perhaps the main benefit of having contingent capital on issue may be the introduction of a new form of monitoring and market discipline of mutual ADI managers. It is well known that most depositor / owners of mutuals do not play a significant role in monitoring management – either in their role as owners or as depositors (and particularly so since the introduction of the Financial Claims Scheme). Holders of contingent capital have stronger incentives to play a governance role – although that is primarily via “exit” sale of securities creating consequent downward price pressure on those securities. How significant an influence that would be on performance of managers of mutual ADIs remains, however, to be seen.



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Disclaimer: Professor Davis is a former director of a small credit union, and also owns shares in Australian banks.

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