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Credit Unions and Demutualization

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ABSTRACT

This paper reviews experience with credit union demutualization to date in the light of increasing discussion about whether demutualization is a likely (or inevitable) future stage in the evolutionary process. It is argued that the credit union industry faces an inherent demutualization bias which emerges as the sector develops maturity. Contributing factors include the emergence of professional management pursuing personal objectives, together with the economic realities of technological change, financial liberalization, increased competition, and prudential regulation based on minimum capital requirements. Demutualization incentives may partially reflect the unsuitability of the mutual form of governance in larger, more sophisticated financial institutions, but there is also a significant risk of demutualization based on wealth expropriation motives. Alternative policies and strategies which might avoid this demutualization bias are examined.

Keywords: Demutualization; Credit Unions; Governance; Regulation

I. Introduction

Although Credit Unions are active in many countries[1], there are stark international differences in their financial sector importance[2], regulation, and range and sophistication of activities. In some countries larger credit unions are indistinguishable from retail banks (with whom they compete), with membership drawn from all income groups[3]. In many other countries, credit unions are in more formative stages of the development process and are typically smaller institutions with more limited product offerings, serving lower income groups neglected by mainstream financial institutions.[4] Consequently, there are marked cross-country differences in issues of current importance.

Demutualization falls into this category, eliciting much (often heated) discussion in countries with a mature credit union sector such as Australia and the USA.[5] It is also relevant for other countries, because regulatory and strategic decisions made in the formative years ultimately influence the evolution of credit unions and long run prospects for their survival as mutual organizations.

If mutuality is seen as a necessary characteristic of credit unions, demutualization is equivalent to demise of the credit union. It is certainly the case that demutualization creates enables new owners to impose a profit objective at the expense of the social goals articulated by credit unions.

It is argued here that the emergence of professional management pursuing personal objectives, together with the economic realities of technological change, financial liberalization and increased competition, create attractive conditions for demutualization. While that attraction may derive partially from the unsuitability of the mutual form of

governance in larger, more sophisticated financial institutions, there is also a significant risk of demutualization based on wealth expropriation motives.

Demutualization is not necessarily a bad outcome if the economic and social functions which credit unions originally evolved to provide are now provided efficiently and effectively by other suppliers (or if the evolution of credit unions has taken their focus away from their original social objectives). But even if that is the case, demutualization involves significant wealth redistribution and thus warrants early attention by credit union leaders and policy makers.

In the following section the concept and process of demutualization is briefly outlined, and followed in Section III by an overview of the limited credit union experience with demutualization to date. To assess why demutualization may occur it is necessary to understand the relative merits of mutuals versus non-mutuals for the provision of financial services. Sections IV and V briefly review the theoretical and empirical literature on this topic. Demutualization suggests that something has changed to remove some prior advantage of the mutual form. Section VI and VII thus considers the theoretical and empirical literature which aims to explain the possible causes of demutualization. Based on this review of the evidence, section VIII presents the main argument of this paper regarding the apparent evolutionary inevitability of a threat to long run survival of the credit union form of organization. Section IX develops some policy implications to influence the evolutionary process and reduce the threat of demutualization based on expropriation motives and draws conclusions.

II. Demutualization: Concept and Processes

Demutualization involves conversion of a mutual organization into a joint stock company with the resulting owner/shareholders having tradable shares carrying an entitlement to a share of profits and one vote per share. It involves several concurrent changes. First, the net worth (capital accumulated from retained earnings) of the mutual, previously owned communally by the members is converted into private wealth (tradable shares). Second there is a change in governance (voting) arrangements (and thus in the nature of agency problems to be resolved). Third, demutualization introduces a new form of external performance measure and capital market discipline in the form of a market price for the tradable shares. Fourth, the constraint on external equity capital raisings imposed by mutuality is removed.

Demutualization may also result from a merger with an existing joint stock company, with members receiving (or being entitled to purchase) either shares in the merged company, or a cash payment. The following discussion focuses initially on a "pure" demutualization with the merger case considered subsequently.

Demutualization could occur by distributing tradable shares free of charge to members according to some allocation formula. In practice, most demutualizations[6] have involved some injection of capital through a sale of stock to members (in addition to any free allocation) and to outsiders.[7]

Demutualization almost always involves windfall gains to some resulting stockholders.[8] If all shares are allocated free of charge to members, the shares issued will have a book value equal to the organization's net worth. If W is the pre-existing net worth and N free shares are issued, book value per share (ignoring costs of the conversion process) will be

W/N. The stock market share price (and realizable windfall gain) may exceed this value if the organization is perceived to have valuable growth opportunities.

The allocation formula determines the total benefit to each stockholder and is thus a contentious issue. Equity would seem to require that allocations reflect the proportion of the mutual's net worth arising from profits on that member's past transactions with it. Typically, net worth accumulates over many years from transactions involving former members (not allocated shares) so that current members experience windfall gains.

Where, instead, shares are issued for sale, windfall gains to subscribers are no less likely. Subscriptions inject funds into the organization, augmenting its net worth by that amount. If M shares are sold at $P each, and no free shares issued, the book value per share will be (W+MP)/M = W/M+P, giving a windfall (book value) gain of W/M per share (or W/MP per dollar subscribed). The setting of the issue terms (number of shares issued and issue price) relative to pre-existing net worth determine the extent of "book value underpricing" and influences the value of realizable windfall gains to subscribers. The allocation formula, determined by directors and management, may involve large subscription rights to such insiders.

If, in addition to the sale of M shares at $P each, N free shares are allocated to members, the book value per issued share will be (W+MP)/(N+M) and the net gain per share to subscribers (in book value terms) is (W+MP)/(N+M)-P = (W-NP)/(N+M). Only if the implied book value of free shares issued (when valued at the subscription price) of NP equals or exceeds the pre-existing net worth of W will there be no windfall gains (in book value terms) to subscribers. If NP exceeds W, investors will only subscribe if they believe that large growth opportunities exist causing the market price to exceed the issue price. If

NP < W, subscribers obtain windfall gains (in book value and, most probably, market value terms). In all cases, recipients of free shares experience windfall gains.

Where demutualization occurs by takeover or merger, members may be offered cash, or shares (or the right to subscribe for shares) in the merged entity. If the cash payment or value of shares received by members (net of subscription amount) is less than the mutual's net wealth, the merger partner receives a windfall gain. Members of the mutual who receive cash or shares at a concessional price also receive a windfall gain.

Demutualization requires majority approval of members.[9] Insiders will have developed and recommended the proposal[10] which will specify an allocation formula for entitlements and involve complex legal documentation. Where membership of the mutual is relatively open, it is possible for outsiders, anticipating potential for demutualization and windfall gains, to join with the intention of inducing such an outcome. While some argue that majority voting limits the possibility of successful demutualization based solely on wealth expropriation motives, the participation of members in governance and ability to understand all the ramifications of such proposals is open to question.

III. Credit Union Demutualization Experience

The limited experience, worldwide, of attempts at demutualization of credit unions has reflected regulatory arrangements in the countries concerned.[11] The following brief case studies provide some flavour of the issues involved.

Australia

In Australia there has been one completed demutualization (via takeover) in 1997, one failed attempt at a "pure" demutualization in 2003, and one unsuccessful hostile takeover attempt in 2003. Industry observers anticipate further attempts.

The 1997 demutualization of Sunstate Credit Union in Queensland involved a takeover by a larger building society. Sunstate had a capital base of around $8 million, high capital adequacy and profitability and approximately 20,000 members. The merger terms involved an offer to credit union members to subscribe for approximately 6 million shares in the acquiring building society at a price of $1.20 each (compared to a current market price of around $2).

These terms implied a windfall gain of around $0.80 per share, or $4.8 million in aggregate, to successful applicants. Nevertheless, there was an implied transfer of value from former credit union members to building society shareholders of around $3.2 million (the $8 million capital base transferred less the windfall gain of $4.8 million to subscribers). Many members (86%) did not participate, although the issue was oversubscribed. Credit union directors (who recommended the merger) and management received significantly larger than average share allocations (which were based partly on the length of membership). Significant wealth expropriation would appear to have occurred, although a court challenge led to a conclusion that the prospectus was not misleading and that the offer was "equitable".

In 2003 Directors of Connect Credit Union in Tasmania ($651 million in assets, 59,000 members, and around $35 million capital) proposed a demutualization giving each member 400 free shares and opportunity for priority subscription for 14.4 million shares to be issued

at $0.75 to raise $10.8 in new capital. Arguments advanced by the Board in support of the proposal included a need for capital to facilitate growth and expansion of activities into areas such as financial planning and SME business, a lack of involvement of members in governance and mutuality, and a desire to distribute tax credits. Demutualization required a yes vote of 75 per cent of members voting. Around 20% of members voted and only 73.7% of those voting were in favour. Hence the demutualization failed.

Had the demutualization occurred there would have been around 39 million shares on issue (24 million allotted to members and 14 million new subscriber shares) and total capital of around $46 million ($35 million initial capital base and $10.8 million newly subscribed), making the book value of each share worth around $1.25. The potential profits for those able to participate in the priority issue or with special allocations were substantial. Anti-takeover restrictions, protecting current management, imposing a 5% maximum limit on shareholdings and one vote per shareholder for the first 2 years after demutualization would have applied.

Also in 2003 a proposed merger between Australian Nation Credit Union ($1.3 billion assets and $131 million reserves) and City Coast Credit Union ($375 million assets and $15 million reserves) was threatened when a local building society proposed a counter offer for the shares of City Coast. This created considerable difficulties for the merger, since *inter alia*, the board of the target were required to act in the best interests of members in comparing and recommending alternatives to members. Since the proposed counter offer involved a cash payment to members which the merger did not, its rejection hinged on arguments to the effect that the benefits to current and future members from continuance as

a merged credit union would exceed the value of the cash payment and becoming non-owner customers of the building society.

Canada

Canada's experience with attempted credit union demutualization appears limited to the case of Surrey Metro Savings Credit Union, where an attempted demutualization via a takeover was rejected by members in 1999. In 1992, Surrey Metro had undergone a restructuring in which non-voting listed common shares were issued (to raise capital) alongside voting preference membership shares. The latter group of stakeholders owned the institution and had control rights, but did not participate in profits or residual value on wind up. The former group had such benefits, but no control rights. In February 1999, Canada Trust made a takeover offer which failed. 70% of the member preference shareholders who voted, voted to reject the offer. (Non-voting common stock holders were strongly in favour of the takeover).

USA

Credit Union demutualization in the USA is a two step process which must proceed first via initial conversion to a mutual savings bank. (Mutual savings banks can offer a greater range of products, are not restricted by a common bond requirement, have more scope to issue securities which count as regulatory capital, and have voting rights linked to deposit balances. Their regulatory capital requirement is 5 per cent of assets compared to 7 per cent for credit unions. Credit Unions, however, are not subject to tax).

At end 2004, 24 cases of such conversions had occurred or were pending.[12] Of these, 7 had subsequently demutualized and 9 had partially demutualized by adopting a Mutual Holding

Company form.[13] There have been a number of cases of members voting against management proposals for conversion to mutual savings bank status.

One example[14] of the US experience is the case of IGA Federal Credit Union, which converted to a mutual savings bank in 1998 and subsequently became one of the first credit union to demutualize in 1999 with 1.8 million shares of stock in Jade Financial Services (the holding company created for the savings bank) offered only to credit union members for $8 per share. Prior to conversion, the credit union had net worth of around $15 million and the injection of new funds increased the capital base to around $29 million. Subsequently in 2001, when shareholder's equity was around $26 million (approximately $14 per share) it was acquired by First Penn Bank at a price of $13.50 per share. The Credit Union Journal Daily for March 15th 2000 reported the event with the headline "Insiders Profit from CU Conversion".[15]

The National Credit Union Administration has expressed the view that there could be around 5 conversions to mutual savings bank status per year and, concerned about credit union member rights and understanding of the process, has proposed new rules to apply in votes for conversion. In particular, proposed rule P708-A (see NCUA[2004]) requires that the information provided to members outlines clearly the changes in voting rights, increased costs arising from ability for directors to receive payment, loss of tax exempt status and costs of conversion, and the potential for executives to obtain significant stock allocations in a subsequent demutualization

Overview

Proposals for demutualization have generally pointed to the need for access to external capital to enable expansion of credit union activities into new areas or to facilitate faster

growth, although other factors such as perceived irrelevance to members of mutuality and tax considerations may also play a role.[16] In some cases, pressure for demutualization has been external, via takeover/merger proposals, while in others it has been internally driven by management. Notably, insiders (directors and management) typically would receive significant allocations of, or opportunities to purchase, stock. There has also been evidence of significant opposition by members[17], leading to some failures of demutualization attempts, despite the fact that members stand to receive a private financial benefit from the process. This suggests that, at least some, members perceive a benefit from continuation of the mutual form of organization, and it is thus important to understand what benefits may exist in such an arrangement.

IV. The Rationale for Mutual Financial Organizations

Although the origins of credit unions are underpinned as much by social and philosophical motives as by economic ones, continued survival in a competitive market ultimately requires that the mutual form of organization does not suffer an overall competitive disadvantage. While credit union industries in the nascent stage of development may be serving members neglected by others, the development process observed internationally to date is one of a transition to involvement in a highly competitive market.

There is a substantial literature[18] comparing the merits of a mutual form of organisation to a joint-stock form. Fundamental to such comparisons is the different nature of the agency problems arising. Mutuals avoid the owner - customer agency problem (although disparate preferences of owners impede agreement on goal-setting), but the mutual governance structure aggravates agency problems between owners and managers. Inefficient or self

serving management can become entrenched, and poorly defined property rights reduce incentives to monitor and discipline management.

In such circumstances, managers of mutuals may act in a risk averse manner to ensure the institution's continuance, their tenure and access to "perks" (including excessive salary). Rasmusen [1988] argues that such behaviour[19] is attractive to poorly informed, risk averse, depositors (not protected by prudential regulation or deposit insurance). This advantage of the mutual form offset the disadvantage of management "expense preference" behaviour. From this perspective, deposit insurance and increased prudential regulation may help to explain the decline of other types of mutual deposit taking institutions (and, perhaps, ultimately credit unions).

Mayers and Smith [2002] use the agency cost perspective to identify types of business activity suited to the mutual form. Where managerial discretion is not important (or is easily controlled) and where owner-customer conflicts would be relatively high, the mutual form may be preferable. Traditional credit union activities of deposit taking, personal lending and provision of transactions services fit this template. Managerial discretion is important for dealing with competitive challenges and this suggests that an environment of low or steady growth and stability of market shares, associated with a regulated financial sector, are also more compatible with a mutual structure.

In the early stages of credit union development where board and management responsibilities and expertise may overlap, owner-management agency problems may not be severe. Increased competition, financial sector development, and the opportunity or need to expand into areas where greater sophistication of operations and management are needed, leads to use of professional management with superior expertise and personal

goals, which can exacerbate those agency problems. Typical of these is managerial desire for larger size which may be desirable anyway for reasons of economies of scale. Implicit restrictions on organizational size arising from a common bond requirement limit managerial ambitions and can lead to pressures for weakening of such requirements.

This restricted membership clientele can provide benefits. Commonality of interests means less conflict over objectives, more likelihood of voluntary inputs, and more incentive to cooperate in exerting control over management. In this regard, greater diversity amongst members – such as arises from growth and expansion of the common bond – will destroy this source of potential mutual advantage. Growth and expanded membership also reduces any advantage which a restricted, socially connected, membership generates for assessing and managing the risks associated with lending activities. The incentives for members to assist in monitoring and disciplining borrower behaviour declines as the membership expands and as a significant accumulated capital base is created, because default by any individual borrower has less potential impact on any other individual member's wealth.[20]

To the extent that credit unions have had an information advantage, it is apparent that several factors have worked towards dissipating this advantage. First, modern technology has improved information about credit worthiness of potential borrowers. Second, public availability of information on defaulting borrowers stored in credit bureaus has increased their cost of defaulting and reduced any monitoring/disciplining advantage of the credit union. Third, the expansion of common bonds and increased size of credit unions has reduced information advantages and social mechanisms for disciplining recalcitrant borrowers.

Homogeneity of membership and low levels of competition are important determinants of advantages of a mutual form of organisation in the analysis of Hart and Moore [1996]. They view decision making in a mutual as reflecting the preferences of the median voter (implicitly assuming that management decisions reflect these preferences). Compared to an externally owned supplier, with the same degree of market power, a mutual with a relatively symmetric size distribution of members will set prices which generate a more efficient output level. With more skewed size distribution of membership the mutual advantage is reduced. With increased competition, inefficient pricing by joint stock organisations will be attenuated, but the mutual's decision making, reflecting median voter preferences, will (if the membership is unchanged) be unaffected, and the mutual advantage diminished.

Although Hart and Moore focused on the trend towards demutualization of stock exchanges, the arguments are relevant to credit unions. Increased skewness in member size, in terms of deposits for example, creates divergences in preferences for higher deposit interest rates versus higher profits and accumulation of communal wealth. Greater competition reduces the ability of the cooperative to set rates different from those of joint-stock competitors. More generally, greater mobility of members and willingness to shift custom to other suppliers reduces the willingness to tolerate non-competitive prices which build up benefits for future members.

Financial liberalisation which removes restrictions on the range of activities provided by financial services firms is also an important consideration. To the extent that there are economies of scope on the demand side (such that customers prefer to purchase a range of services from one institution rather than separately from a range of institutions) specialist

suppliers of certain services may be at a competitive disadvantage, giving managers incentives to broaden the service range into new areas. Emmons and Schmidt [2004] note that employer subsidies to occupational credit unions may enable such specialised institutions to coexist with banks offering broader ranges of retail banking services.

V. Is there a Mutual Disadvantage? The Evidence

A number of empirical studies have compared the performance of mutual and joint stock companies operating in retail financial services in different countries (particularly the USA). The evidence is mixed. Some early studies such as Estrella and Greenbaum [1988] and Verbrugge and Jahera [1981] found some evidence of greater expense preference behaviour for US mutual S&Ls. However, Gropper and Hudson [2003] find that increased competition in the 1980's removed (as would be expected) most evidence of any such difference.

Focusing solely on expense preference behaviour ignores the possibility of other advantages arising from the mutual form. A number of studies focusing on broader measures of operating efficiency, and allowing for expected differences in activities of mutuals and joint stock companies to be reflected in different product mixes and cost functions find somewhat conflicting results.[21] On balance, there is no clear evidence of differences in average efficiency, but strong support for the finding that the two groups undertake different types of activities which is reflected in different production technologies each suited to those activities. Cummins, Weiss and Zi [1999] find similar results for US insurers, but also find some evidence of expense preference in mutuals, and that this agency problem increases in significance with the size of the mutual organization. For UK building societies, studies by Valnek [1999] and Ashton and Letza [2003] which

examine return on assets and deposit interest rates respectively, seem to suggest better performance by mutuals although both studies have the disadvantage of focusing on only one aspect of performance.

An Assessment

The available evidence does not provide support for the proposition that mutual financial services firms are inefficient relative to joint stock firms offering the same range of services. Hence proposals for credit union demutualization premised on no change in the traditional range of activities to be undertaken would not seem justified on efficiency considerations. However, demutualization may be driven by other motives, including expansion into activities where the mutual form is less suited. The next section considers this possibility.

VI. Motives for Demutualization

Mayers and Smith [2002] provide a useful taxonomy of motives for demutualization, identifying three, non-mutually exclusive, possibilities. The first is the removal of the growth constraint imposed by lack of access to external capital. Where there is low growth, market stability, and ability to meet capital needs from retained profits (such as when competition is relatively low and a return on equity at least equal to projected asset growth can be achieved), there will be less incentive for demutualization. The second is the desire for entry into business lines not suited to the mutual form such as those where managerial discretion and increased risk taking plays and important role and thus warrants stronger control mechanisms. The third motivation is the potential for wealth transfers arising from the conversion of communal wealth of the mutual into private wealth (in the form of tradeable shares in the demutualized joint stock company).

The first two of these motives can be described as "efficiency-based" hypotheses of demutualization, although a desire for rapid growth or entry into new business lines could also be driven by managerial ambitions, not necessarily in the best interests of members. The last motive can be described as a "private wealth based" or "expropriation-based" hypothesis.

While most discussion of this latter hypothesis focuses upon expropriation by decision-makers in the mutual (executives and directors) who typically stand to gain a disproportionate share of issued stock, Davis [2001] provides an alternative perspective. Demutualization involves the conversion of communal wealth available to facilitate services to future members into private wealth of current members. Thus, depending on their stage in the life cycle and likelihood of continued involvement in the mutual, current members may have an incentive to vote for demutualization even if it destroys some unique advantage which the mutual structure possesses over the alternative joint stock form. This possibility is increased if membership of the mutual is relatively open and new members can join in the expectation of forcing conversion and sharing in the privatization of the communal wealth.

While some authors interpret a demutualization in which no current stakeholders experience a decline in private wealth as not involving expropriation, an alternative interpretation, favoured here, is that conversion of communal "inherited" wealth from past members into private wealth for current members is a form of expropriation at the expense of future members.

VII. Demutualization and Performance: The Evidence

A number of studies have assessed whether performance of financial firms after demutualization gives support for the efficiency hypotheses regarding motives for demutualisation. These studies have had to rely on accounting or operating measures of performance, given the non-existence of pre-demutualization share prices, and have generally focused on the initial years following demutualization.

Studies by Schrand and Unal [1998], Simons [1992] and Carhill and Hasan [1997] find evidence of increased risk taking by US thrifts post demutualization. The latter two studies also find some evidence of poorer performance and Carhill and Hasan find evidence that demutualized thrifts had already shifted towards a different (more risky) mix of business prior to demutualization.

Studies which provide support for efficiency hypotheses for changing organizational form include Masulis [1987] for US S&L demutualizations, Mayers and Smith [1986] for mutualizations by previously joint stock life insurers in the US, McNamara and Rhee [1992] for US life insurer demutualizations, and Mayers and Smith [2002] for US property and casualty insurer demutualizations. Results emerging from these studies include evidence that competition and growth prompt demutualization, as does movement into activities requiring specialized management, and constraints on growth due to lack of access to external capital.[22] This positive support for the efficiency hypotheses is reinforced by the finding of Cole and Mehran [1998] that demutualised US S&Ls exhibit superior share price performance after temporary anti-takeover limitations on share ownership expire and when management increase their ownership stake.

These studies tend to find that demutualization increases the value of the organization by more than the proceeds raised in the sale of stock[23], and that no group of post conversion stakeholders is disadvantaged. These findings are consistent with an efficiency perspective on conversion, although several caveats need to be entered. First, the market value post conversion might be reflecting pre-demutualization "franchise value" of the organization rather than gains from demutualization per se. Second, while successful investors in the stock benefit, the (voluntary, albeit ill-informed) non-participation of many pre conversion members in the stock issue, and loss of ownership rights, needs also to be considered. Third, the finding that management generally realizes large wealth gains arising from conversion does not rule out some element of simultaneous wealth transfer / expropriation motives. These studies generally do not place any emphasis on the wealth transfer arising from the conversion of the communal wealth (capital base) of the organization into private wealth

Several studies have examined the distributional effects of demutualization and shed some light on the merits of the expropriation hypothesis. Maksimovic and Unal [1993] found that many priority investors (depositor-members) chose not to subscribe for stock in US S&L demutualizations (and thus effectively lose their entitlement to the pre-existing net worth). They also find that more valuable thrifts have larger stock issues, leading to a positive association between issue size and the size of first trading day profits which benefit investors such as the managers who generally have larger subscriptions in these cases.[24] Simons [1992] also argues that demutualization was driven partly by expectations of personal gain of managers who, on average, acquired 20 per cent of all shares issued. Cook, Deakin and Hughes [2002] argue that changes in the UK Building

Societies Act 1986 altered property rights and prompted demutualization such that the principal beneficiaries of change were corporate managers and speculative investors at the expense of borrowers and of communities resulting from changes in range of services provided. While suggestive of expropriation motives, these results are not inconsistent with the efficiency hypotheses.

An Assessment

There is strong evidence that demutualization is proposed when changes in the operating environment reduce the perceived advantages of the mutual form of organization or when decision makers wish to undertake new activities for which the mutual form is not appropriate. Increased competition and unexploited growth opportunities which require additional capital are among these drivers of change. At the same time, evidence that demutualization generates aggregate net benefits does not preclude the possibility that expropriation of communal wealth by insiders is also an important motive. It is clear that significant wealth transfers do occur, particularly when poorly informed members of the mutual do not participate in the sale of stock. Insiders achieve significant wealth gains, and their entrenched positions may often be shielded for some time from the effects of demutualization by transitory anti-takeover and voting restrictions. Although demutualization requires support from members, the conversion of communal wealth to private wealth provides an incentive to support the demutualization unless significant benefits from continuation of the mutual form are believed to exist. If mutuality and the social purpose of the organization have ceased to matter to members, and if they have many alternative suppliers of financial services, they may have no incentive to oppose demutualization, even if the mutual form has some inherent economic advantages.

VIII. Demutualization Bias in Credit Union Evolution

The preceding sections have identified factors which create conditions likely to lead to demutualization. These include increased competition, increased size and diversity of members, capital constraints on growth, managerial preferences for entry into new business areas, and expropriation incentives stimulated by accumulated capital reserves.

International experience with the evolution of the credit union sector into the mature phase of development has been characterised by a number of these factors, prompting a "demutualization bias" currently becoming evident in Australia and the USA. Whether the development patterns observed so far, which lead to this outcome, are the only ones possible, and how they might be affected by policy decisions in earlier stages of development are important social and economic questions.

Increasing sophistication of credit union activities and greater integration into a competitive financial system create problems for the survival of the mutual form. Employment of professional management with superior knowledge and expertise is required and increases the owner-manager agency problems which bedevil the mutual form. Competition with other financial institutions limits the ability of these managers to engage in simple forms of cost increasing expense preference behaviour, but does not prevent attempts to expand the size of the credit union. Links between remuneration and asset size and the existence of a competitive managerial labour market encourage such behaviour, which can exhibit itself in attempts to widen common bonds, mergers with other credit unions, and expansion into newer areas of activity. Professional management, less imbued with the social goals of credit union founders, can also be expected to pursue commercially attractive business,

creating a change in focus towards acquiring member-customers from higher income groups, rather than the original clientele of the credit union.

Desire for increased size and range of activities can, of course, also be driven by simple economics. The existence of economies of scale (over some output range) in credit unions is well established, while customer preferences for "one-stop shopping" for a range of financial services available at competitors can necessitate an expansion in product range, even if standard economies of scope on the cost side of the equation do not exist.

With both managerial ambitions and the economics of the production process encouraging increased scale and range of activities, increasing concentration of the industry and emergence of large credit unions is a natural consequence. Therein, however, lie the potential seeds of mutual destruction, for four interrelated reasons.

First, as previous studies have shown, large scale operations and expansion into non-traditional activities are features suggestive of a need for managerial discretion with which the mutual governance form is not well placed to deal. Providing members with an expanded range of activities similar to those provided by joint stock competitors takes the credit union into areas of increased risk, where the (arguably) stronger managerial control mechanisms of the joint stock form provide advantages.

Second, expansion ambitions are constrained by ability to generate capital from internal sources. Pricing which generate profits is required to increase capital, so that any net benefit which the credit union could provide to members is reflected in accumulation of capital rather than in better terms (prices and interest rates) in dealing with current members. While (in the absence of deposit insurance) members benefit from an increase in the safety of their deposits, much of this benefit accrues to future member depositors. In

this regard, the imposition of minimum capital requirements for prudential regulation purposes reinforces the demutualization bias inherent in credit union development.

Third, increased size creates the risk of losing the informational and monitoring advantages possessed by a small mutual. Increased diversity of member interests and needs also threatens the mutual advantage. Without a clear goal of profit maximization, managers of a mutual must (implicitly through price setting) allocate net benefits arising from the mutual form across members with diverse interests. While competition and the threat of exit constrains managerial flexibility in this regard, increased member diversity and conflicting preferences further complicates the owner-manager agency problems of the mutual form.

Fourth, accumulation of a sizeable capital base makes expropriation of the communal wealth via demutualization a feasible and attractive proposition. In this regard, the increased concentration of the credit union sector arising from growth in size of credit unions due to expansion of common bonds and mergers is particularly ominous. Because it concentrates the communal wealth of the credit union industry into a smaller number of larger pools, the relative cost of expropriation activities (including demutualization expenses) falls. Demutualization is less likely to be opposed if the membership is widely dispersed with little affinity for the credit union as a social institution as would be expected to be the case in large credit unions with loose common bonds. This can arise also when the membership base comprises many individuals who are able to access similar services from alternative suppliers on competitive terms.

These arguments lead to the hypothesis that credit union demutualization is likely to occur when the following conditions apply. First, large credit unions with large capital bases and disparate membership are more likely to demutualize. Second, demutualization is more

likely when there is heightened competition which restricts the ability of credit unions to accumulate capital by making and retaining profits, and in periods where opportunities for growth exist. Third, as credit unions move outside of their traditional, relatively low risk, areas of activity and professional managers gain increasing influence, demutualization becomes more likely. These are all characteristics which have emerged in the evolutionary process followed by the Australian and USA credit union industries, where demutualization has become an issue of current importance.

IX. Policy Implications and Conclusion

If widespread credit union demutualization is a high probability event in economies with a mature credit union sector, important policy issues are raised for economies at all stages of credit union development. Because the communal wealth generated over time by the credit union's activities is likely to be ultimately converted into private wealth, there are significant distributional issues to be resolved.

For economies with a mature credit union sector in which demutualization is already an issue, an important policy consideration is whether demutualization is proposed primarily for purposes of wealth expropriation. In such circumstances, a valuable social asset may be destroyed for private gain, if the mutual form has some remaining competitive advantage. Blanket prohibition of demutualization is not an appropriate response, since that may prevent efficiency gains, if the mutual form is no longer advantaged due to environmental changes.

One way to partially counteract the demutualization bias is to provide mechanisms for credit unions to access some form of external capital, consistent with the mutual form. In Australia, issuance of non-voting preference shares or subordinated debt which counts as

Tier 2 capital is an emerging trend, although regulatory limits on the maximum proportion of total regulatory capital taking this form still constrain growth. In Canada, special shares or investment shares perform a similar role. Mutual Holding Companies, increasingly common among US Mutual Savings Banks, are another alternative for providing access to external capital, but do not resolve governance problems of the mutual form.

Whether such capital innovations overcome the demutualization bias depends on whether the cost of capital raised in such a way is attractive relative to the alternatives available from demutualization. Another alternative is the development of financing techniques which economise on capital requirements, such as securitization of loans. Neither of these innovations, however, resolves any demutualization bias associated with expansion into areas of activity where the mutual form of governance is unsuitable.

As explained earlier, there is no way of preventing at least some individuals obtaining windfall gains from demutualization (unless the ownership of the net wealth of the institution is transferred to some entity such as government or charity). However, it is important, on both efficiency and equity grounds, to ensure that wealth expropriation does not drive the decision-making process.

If it is believed inappropriate for non-members to receive windfall gains (due to privatization of the mutual's accumulated net worth) from subscribing to a stock issue, the analysis of Section II points to a simple policy solution. Requiring that free shares be allocated to members with a total implied value (based on the issue price for subscription shares) equal to the credit union's net worth would mean that windfall gains to subscribers are limited to the growth opportunities of the organization as reflected in the difference between book and market value of shares.

Such a policy does not, by itself, overcome the problem that the distribution of windfall gains to members depends upon the share allocation formula. Since membership of those credit unions with wide (or no) bonds is easy to access, the danger exists of "carpetbaggers" becoming members, achieving positions of influence and initiating demutualization with excessive allocations to themselves at the expense of long standing members. Even without that risk, existing insiders can determine the allocation formula to favour themselves.

To counter this problem, a second requirement would be the imposition of strict limitations on the maximum free allocation which any insiders could receive. While this would, no doubt, be anathema to many managers and directors interested in pursuing demutualization, an alternative mechanism is available to enable them to share in any efficiency gains from demutualization. Specifically, priority entitlements to subscribe for shares would put to the test their faith in the benefits of demutualisation – since such shares would trade at prices higher than issue price if the market shared their belief in the efficiency gains and merits of demutualization.[25]

There is also some merit in the argument that government should receive some allocation of free shares in a demutualization (for subsequent resale), similar to that proposed (but rejected) in 1994 for S&Ls in the USA[26]. If government has provided underpriced (explicit or implicit) deposit insurance or preferential tax treatment over a number of years to credit unions, some part of the wealth accrued has been at the expense of taxpayers. If so, government would appear to have a claim of at least equal merit to current members over some part of the communal wealth to be privatized. By reducing the total of private net

wealth received by members relative to communal wealth, the incentive to demutualize is likely to be reduced.

For countries with credit unions in more formative stages of development, and for whom the demutualization issue is not yet so immediate, the policy issues relate both to permissible industry developments and the appropriate approach to capital adequacy and ownership claims.

Ultimately, demutualization becomes attractive because the credit union form has lost its inherent advantages due to growth and expansion of activities (as well as changes in the external environment), and because large size and capital base makes expropriation of the wealth of individual credit unions attractive and feasible.

Unfortunately, for long run survival of credit unions, policy suggestions and industry strategies which reflect economic realities seem designed to encourage industry developments along the path ultimately leading to high probability of demutualization. For example, a UK Task Force on Credit Unions argued that "The key elements in a growth strategy include: larger individual C[redit] U[nion]s; professional management; capacity to offer a wider range of services;.." (HM Treasury [1999], para 31).

To the extent that economic realities force such a development path, then it may be that demutualization is ultimately an efficient mutation for credit unions. However, it would be appropriate to manage the development process in such a way that demutualization does not occur for motives of expropriation only. To do so involves paying attention to, and appropriately specifying, the property rights associated with accumulated capital before it becomes a "problem".

One radical approach would be to note that capital in financial institutions is used as a buffer to absorb losses and protect depositors. Regulatory capital requirements are applied to credit unions with this objective even though, as argued by Davis [1994], the congruence of owners and depositors means that the typical rationale of a separate ownership stake protecting depositors is less applicable in a mutual.

But capital requirements are not the only mechanism for achieving this objective of protecting depositors. Deposit insurance is a substitute, involving annual contributions into a central fund, which if greater than fund payouts due to failures by members, leads to an accumulation of wealth in the deposit insurance fund. An alternative to the generally favoured approach of relatively high required capital ratios would be to adopt much lower capital requirements but charge higher annual deposit insurance premiums. Such premiums would lower annual profits and thus accumulation of capital within the credit union, but lead to a communal accumulation of capital within the deposit insurance fund.

Expropriation incentives to demutualize and exit the credit union industry would (provided that there was no reimbursement from the deposit insurance fund) be diminished because of the lower net worth of the individual organizations. Most of the communal wealth of the credit union industry would be maintained in a central fund in perpetuity. Where efficiency considerations justified a demutualization of an individual credit union, this could proceed by way of a "sale of stock" process to generate a capital base to enable the institution to operate as a different type of financial services firm using the organizational skills and assets built up over previous years of credit union operations.

Undoubtedly there are alternative possibilities which would appear less radical and, perhaps, less threatening to individual credit union managers to whom accumulation of

capital is often regarded as an indicator of performance. It is important, however, that early in the developmental stage of credit unions the threat posed to ultimate survival as mutuals by accumulation of capital is recognised and mechanisms established to prevent expropriation, rather than efficient mutation, being the cause of the demise of the industry as originally established.

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END NOTES

[*] This paper was completed while a Visiting Senior Research Scholar at the School of Management and Economics, Queen's University Belfast.

[1] At the end of 2003 there were 40,421 credit unions, operating in 84 countries with 123 million members, affiliated with the World Council of Credit Unions

[2] International comparative data can be found at https://www.woccu.org/pdf/stateng03.pdf.

[3] The US GAO [2003] study concluded that "income of credit union members is similar to that of bank customers" (p4).

[4] Sibbald, Ferguson and McKillop [2002] provide more detail and classify credit union industry development into categories of nascent, transitional, and mature.

[5] In the USA, for example, the then NCUA Chairman Dennis Dollar "said he thinks key credit union issues for the future will include…..demutualization……" CUNA [2003].

[6]Recent examples of demutualization "waves" include building societies in the UK and Australia, S&L's and Mutual Savings Banks in the USA, and insurance companies in a number of countries.

[7] Unal [1997] provides a description of demutualization methods permitted by US regulators of the S&L's.

[8] The one exception is where no free shares are distributed and the market price of shares sold turns out to be below the issue price. As explained below, this is an unlikely occurrence.

[9] In many cases a super majority and some minimum proportion of members voting is required.

[10] Unless it involves a hostile takeover attempt – if such is permitted by law.

[11] WOCCU [2000] provides information on the relevant regulatory arrangements in several countries.

[12] A listing of credit union conversions as at end 2004 can be found at http://www.cufinancial.com/Update.htm .

[13] This involves creation of mutual holding company owned by members which owns at least 50 per cent of the stock in (and thus retains control of) a joint stock operating company providing financial services. The remainder of the stock in the operating company is sold to members or external investors, raising additional capital.

[14] Some case studies of conversions to mutual holding companies can be found at http://www.cuconversions.com/

[15] http://www.cujournal.com/archive/000315.htm

[16] In Australia, a tax disadvantage for mutuals arising from their inability to distribute tax credits creates an incentive for demutualization, whereas in the USA the non-taxed status of credit unions creates a disincentive.

[17] In the US cases, these have been votes against the first step of conversion to a Mutual Savings Bank. The subsequent step is less likely to be rejected, since votes are linked to deposit balances enabling large investors who desire and will benefit from demutualization to exert voting power in support.

[18] See for example Hansmann [1996] and Baker and Thompson [2000] who focus specifically on the financial services industry.

[19] This reflects lower operating risk and pricing aimed at generating surpluses and a higher capital base.

[20] A related argument can be found in FSA [2003, p3] "The sense of obligation to save and repay among the members of credit unions would be greater than among persons dealing with an ordinary commercial provider."

[21] These studies include Mester [1993], Cebenoyan, Cooperman, Register and Hudgins [1993], Sfiridis and Daniels [2004] for US S&L's, Hutcheson and Sharpe [1998] for Australian Building Societies and Hasan and Lozano-Vivas [2002] for Spanish banks.

[22] Stephens [2001] finds no one factor dominates in a case study based review of motives for demutualisation of UK building societies, but argues that structural changes in the financial market place do not provide the explanation.

[23] Using the notation of Section 2, the issued shares commence trading at a price in excess of W/M+P.

[24] Colantuoni [1998] notes that first day share price gains for the 143 converting thrifts from 1995 to mid 1998 were on average 24 per cent, despite regulatory changes in 1994 prescribing allowable terms for conversions (see also Unal [1997]) which were driven by public policy concerns that conversion windfalls have accrued disproportionately to insiders and profession investors at the expense of depositors.

[25] Note, however, that an excess of the market price of shares over the subscription price could reflect the growth opportunities of the organization prior to demutualization rather than additional gains from demutualization.
[26] See Barth, Brumbaugh and Kleidon [1994].