DRAFT 29 December, 2009

Organisational Forms for Financial Services Firms

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Prepared for the Melbourne Money and Finance Conference

Sebastapol, Vic, November 28-30, 1996

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Abstract:

A large variety of organisational forms can be found in the financial services industry, ranging from unincorporated enterprises, through partnership, unit trust and mutual structures, to joint stock firms. Different forms have been predominant over time in particular areas of financial services, although a trend towards the joint stock form appears evident in recent years. This paper addresses the question of whether there is any optimum organisational form for provision of particular financial services and asks what, if any, regulatory constraints on organisational form might be justified. It also considers reasons for the apparent trend towards the joint stock form as the dominant form of organisation.

Organisational Forms for Financial Services Firms

The history of the financial services industry is littered with examples of different organisational forms. A current (international) trend appears to be the conversion of many organisations from mutual form to joint stock form. At the same time, however, there has been a growth in the importance of collective investment style organisations (unit trusts, mutual funds etc.). The former trend involves a move towards greater separation of owners and customers, while the latter involves growth in organisations where no such distinction is made. These trends are of interest because of their implications for the allocation of risk bearing in the economy, for corporate governance issues, and for the structure of prudential regulation..

The objective of this paper is to examine how organisational form matters for financial institutions, and to address whether choice of institutional form has implications for social and economic policy. In particular, it needs to be asked whether the trends currently being observed reflect "efficient mutations" or whether they are being induced, advertently or inadvertently, by regulatory factors which favour one institutional form over another. An argument of the paper is that current prudential, regulatory, and tax systems are biasing organisational form choices, partly because these systems are premised on an implicit assumption that the joint stock form is the "natural" form for financial institutions. This, it is argued, is open to question - particularly given the advances in financial engineering of the past two decades which have blurred distinctions between financial instruments and enable alternative organisational forms to be constructed - legal and regulatory conditions permitting[1]. The fact that, for example, prudential policy sees

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[1] In the late 1980s, for example, there were proposals advanced in the USA for the creation of unbundled stock units (USUs) on certain companies which separated common stock into three components, involving a separation of voting rights and different components of return.

merits in linking "capital" to liabilities for deposit taking institutions[2] and life offices, does not necessarily imply that the joint stock form is the appropriate form for these organisations. Financial engineering should be able to design an alternative form which achieves the same regulatory goal, without adopting all the characteristics of the joint stock form.

The arguments of this paper can be viewed as an application of Kane's "regulatory dialectic" notion of the evolutionary behaviour of the financial system (Kane, 1977). Regulation can prompt innovative responses and adaptation not just in terms of securities or activities, but also in terms of organisational forms, with those changes prompting further regulatory adjustment.

2 Some Historical Examples

History provides ample evidence of the ability of different organisational forms to operate effectively in the financial services industry under certain conditions. Studies of unregulated banking (White, 1984) have outlined how unlimited liability of bank owners was a characteristic of free banking in Scotland when bank failures were relatively rare. Likewise, unlimited liability has characterised the operations of Lloyds of London insurance over several centuries.

Unlimited liability also characterises the activities of partnerships, which were the dominant, indeed only, institutional form allowed in Australian stockbroking prior to deregulation of the mid 1980s. In commenting on this, the Campbell Inquiry (1981) noted that

> "The present entry rules may be said to impede the operational efficiency of the industry by dictating the business structure which brokers must adopt." para 33.121

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[2] There have been several proposals advanced (without success) to remove the problem of depositor safety and need for capital requirements by requiring the adoption of "mutual fund" banking.

Partnerships are also common in the accounting and legal professions. Alternative structures which combine elements of the joint stock and partnership form have been common in the USA in the form of master limited partnerships. In this structure, a general partner has unlimited liability and management responsibility, while limited partners enjoy limited liability. This structure enables tax and other organisational benefits of the partnership structure to be achieved while preserving limited liability for providers of funds. Changes to the Australian tax laws in 1992 stifled an emerging interest in this form of organisation.

Mutual and cooperative organisations have also been significant in most financial systems. In Australia, the mutual form has, until recently, dominated the life insurance business, and mutual life offices are common elsewhere. In the mutual form, customers are *de jure* owners, but in practice *de facto* ownership typically resides with the management. The Campbell Inquiry (1981) for example presented data on voting involvement of mutual life office policy holders, shown below as Table 1, demonstrating the clear divorce between ownership and control.

Table 1: Mutual Life Offices: Policy Holder Voting, 1980

	Ordinary Policies on Issue	Voters on postal voter's roll	Number voting at AGM
AMP	2,374,608	55,675	12300
National Mutual	1,112,566	6,525	na
T&G	886,979	131	na
Colonial Mutual	599,099	62	na
City Mutual	199,922	19,500	na

Source: Campbell Inquiry (1981) Table 20.2

The mutual form has also been significant in the deposit taking and lending industry, with UK Building Societies, US Savings and Loans and Savings Banks, and Australian Building Societies having adopted this form. Cooperative organisations have also been common, most notably in the form of credit unions. In both cases, owner/customers are residual risk bearers, but subject to limited liability. In developing countries ROSCAs (Rotating Savings and Credit Associations) have been an important organisational form (see Besley , Coate and Loury, 1993)

A further set of organisational structures is that referred to as collective investments. Unit trusts (mutual funds) come under this category, and involve a structure whereby residual risk bearers (the investors) have limited liability and limited voting rights, with management undertaken by a specialist management company. Superannuation funds are also of a similar form, whereby a group of trustees has control. An alternative description of this group is that of managed funds. As well as the risk bearing and control aspects, it is noticeable that these organisations are characterised by a significant degree of "contracting out". Advice (asset consultants) and investment management and other functions are often performed by third parties under contractual arrangements.

While the private joint stock form now dominates the Australian financial system (or certainly will following demutualisation of large life offices) it is useful to reflect on the novelty of this situation. At the time of the Campbell Inquiry, private joint stock companies held only slightly over 50% of banking sector assets, stockbrokers were all partnerships, mutuals dominated the life assurance industry, etc.. Since then, financial intermediation has become increasingly dominated by the joint stock form, although collective investments have grown in significance.

3. Differences in Organisational Form

The preceding very brief overview of alternative types of organisational forms indicates a number of different characteristics which may be of relevance in design of a financial institution. They include the following.

Liability of Owners: Some organisational forms, such as the joint stock company, limit the liability of owners to the amount already invested, while others allow for personal liability beyond that amount.

Organisational Objectives: Some organisational forms have a clear objective of maximisation of owners' wealth, whereas others (where owners and customers are the same group) have less clear objectives of welfare maximisation

Taxation Treatment: Governments have over the years applied different taxation rules to different types of organisations

Capital: Under some institutional forms it is not possible to raise equity capital externally

Governance: Entitlements to voting rights and control mechanisms differ across different organisational forms.

Organisational forms differ across this range of characteristics, creating a dilemma for policy. Where certain characteristics may be viewed as particularly important (such as a non withdrawable capital base) policies which focus upon that characteristic may encourage the dominance of particular organisational forms with other characteristics not necessarily viewed as desirable.

4. Theory of Organisational Structure

Business organisations can be seen as a nexus of contracts which involve *inter alia*, risk sharing arrangements, and control rights. Different organisational forms involve different methods of allocating risk and control rights and, because of the impossibility of complete contracting, lead to different forms of agency problems. Mutual and cooperative institutions, for example, may benefit from the absence of an agency problem involving owners and customers (who are one and the same). Exploitative behaviour by unscrupulous owners may be avoided, making these institutional forms particularly suited towards market based minimisation of consumer protection problems. On the other hand, agency problems involving management may be relatively severe, because of the control problems arising from the allocation of owners' voting rights and the absence of stock market discipline. This leads to two offsetting effects. First, managers may prefer low risk activities (to ensure survival of their sinecure) giving such institutions a competitive advantage taking the form of a perception of low risk which is attractive to risk averse, poorly informed, investors. Second, management may have little incentive to maximise efficiency, giving other institutional forms, such as the joint stock form, a competitive advantage.

The variety and changing importance of different organisational forms can be explained in at least two ways. One view, perhaps best referred to as the Efficient Markets - Invisible Hand view, applies the Darwinian survival of the fittest perspective to suggest that market forces lead to efficient organisational forms surviving. In this view, those organisational forms which best solve the contracting problems associated with a particular activity will survive and prosper. Conversions from one form to another, in this view, indicate recognition that a more efficient organisational form is available, reflecting changes which have occurred in the external environment. Note however, that the external environment prompting such changes includes regulatory and tax factors, such that a particular form may have no inherent advantages but be better suited to coping with a particular regulatory or tax regime.

Fama and Jensen (1983a, 1983b) have provided an analysis of alternative organisational forms which adopts this "efficient markets" view. They distinguish decision management and decision control aspects of business organisations. Where decision management is a complex task (such as commercial banking), the agency problems created by separation of ownership and control are argued to warrant the joint stock form. Decision control by "exit" (withdrawal of funds) is not viable given the illiquid nature of assets, thus requiring decision control by "voice" (voting rights). In contrast, where exit is a feasible control mechanism (unit trusts, thrift organisations ?), a mutual organisation may be efficient since it avoids owner - creditor agency problems.

An alternative (polar) perspective on choice of organisational form might be called the Exploitative - Self Interest view. In this view, organisational form is chosen by the promoter(s) of the organisation to maximise the gain to the promoter in an imperfect world. In this view, conversions from one form to another reflect the self interest of decision makers, and are exploitative - aimed at redistributing wealth between stakeholders in the organisation, even if there is no gain (or even a loss) in efficiency from the new form. Davis (1996) provides an analysis of how such outcomes can occur in the case of cooperative financial institutions.

5. Social Policy and Organisational Form

Should government policy restrict or encourage particular organisational forms within (different parts of) the financial services industry? There would appear to be several considerations of relevance.

First, is the total risk of the financial system affected by the nature of the organisational forms prevailing? At one level, the answer to this would appear to be no. All that organisational forms do is to repackage and redistribute the risk within the economy. However, if decision making as regards risk differs between organisational forms or if policy concerns are focused upon the distribution of risk, there may be a reason for interest.

Second, is coping with financial distress/ institutional failure easier in some organisational forms than in others? For financial supervisors, an important concern is to ensure smooth exit of organisations in financial distress. It may be that it is easier to facilitate exit for some forms.

Third, which organisational form is inherently more efficient for the conduct of particular activities? Policy can induce the choice of a particular organisational form, even if that is not naturally the most efficient form for that activity.

6. Regulations, Tax and Organisational Form

Several distorting regulatory and supervisory influences on the choice of institutional form can be readily observed.

Government guarantees

Government guarantees (whether *de* jure or *de* facto) over invested funds (eg deposits) provide a clear competitive advantage for institutions involved, unless an actuarially fair insurance premium is paid by those organisations to the government. Moreover, to the extent that public perceptions of such guarantees can be spread across the entire range of business undertaken, the size of benefit provided is magnified. There are two aspects to this.

- First, In the absence of such guarantees, forms other than the joint stock company, such as mutuals, were prevalent - and could be argued to be perceived as being naturally lower risk. “Cheap” insurance is more advantageous to the higher risk institutions, and the relative decline of mutuals etc at the expense of joint stock companies could be arguably partially attributable to the distortion created by such cheap insurance.
- Second, in Australia, it can be argued that public perceptions are that banks are protected by government. Since, currently, only joint stock companies can hold banking licences there is a distorting effect in favour of the joint stock form. Since banks can operate across virtually the entire spectrum of financial services, this induces further bias towards banking status and thus the joint stock form.

Regulatory Entry Barriers

Currently, the AFIC Legislation involves a “Catch 22” provision which inhibits the creation of any new cooperative financial services firms. Minimum capital requirements, as a proportion of (risk weighted) assets are imposed, but allowable capital is restricted to a form (such as accumulated retained earnings) which can only be achieved from previous operations.

Capital Requirements and Cooperative Institutions

Capital requirements imposed on cooperative financial institutions have a number of adverse effects, and can be argued to be based on transposition of an argument relevant for one institutional form to the case of another to which it is not so obviously relevant.

The fault in logic in applying capital requirements to cooperatives arises from the notion that there is a group of stakeholders separate from customer / depositors whose equity stake provides a buffer of protection for depositors. This notion makes sense in the case of a joint stock company, where owners and depositors are separate groups, but makes no sense in the case of cooperatives (see Davis, 1994). Capital of a cooperative is the communal property of the member/ customers, and accrues from retained earnings of the cooperative in its dealings with members. Should the cooperative make a loss (eg from loan defaults), the loss must be borne by members as the residual risk bearers. A larger capital reserve simply means that the loss is accounted for in the decline in communal wealth rather than in private wealth held in deposit accounts. There may, of course, be good psychological reasons as to why the effect of a loss of communal wealth is regarded as of less significance than a loss of private wealth, and therefore for that outcome to be preferred. By the same token, if communal wealth is not highly valued, the protection it affords to private account wealth will induce a lower level of monitoring by depositors and thus aggravate agency problems.

Such capital requirements provide an inhibition to the operation of cooperative organisations since they limit their ability to expand in the face of increased demand for their services. Growth rates are constrained by the availability of internally generated capital, and a faster growth rate of internally generated capital requires operating with a larger “spread” to the detriment of current members - and partially choking off increased demand.

A third concern is that capital requirements lead to the build up of significant amounts of "communal wealth" in cooperative and mutual institutions. This is potentially subject to expropriation into private wealth through a conversion process. Even if there is an inherent efficiency advantage of the cooperative form, it may be to the advantage of a majority to vote for conversion -since their share of communal wealth captured may exceed their loss of benefits from the greater efficiency of the cooperative.

Taxation

From time to time, governments apply differing tax rules to different types of financial services or to different types of organisations. Until recently, for many years credit cooperatives had not been subject to company tax. Superannuation funds have been subject to favoured tax treatment. Friendly societies experienced their boom growth years by utilising their concessional tax treatment to design attractive products such as Friendly Society Bonds.

Recently, the tax treatment of credit cooperatives was changed to subject them to company tax, supposedly to "level the playing field". In fact, under the dividend imputation tax system, the inability of cooperatives and mutuals to distribute franking credits arising from company tax paid, creates an unlevel playing field vis a vis other institutional forms. When members are from lower income groups and thus on a lower tax rate than the corporate tax rate, the franking credits "locked up" in the organisation are wasted instead of being available to offset tax on other income of member/owners.

A countervailing effect of the introduction of dividend imputation has been the removal of some part of the tax bias against the joint stock form *vis a vis* the partnership form. Imputation has meant that the double taxation of the income stream of a company paid as dividends to owners no longer occurs. However, the ability of partners to deduct losses incurred by the business against other income earned in the same year, remains a tax advantage of this form relative to the corporate form where such losses can only be carried forward.

Regulatory Service Fees

Cooperative and mutual organisations supervised by AFIC are required to contribute to fund the operating expenses of AFIC, whereas banks make no such direct contribution to fund Reserve Bank expenses (although payment of below market interest rates on Non-Callable Deposits can be seen as an indirect contribution).

7. Conclusion

The design of a financial system involves more than just a focus upon financial products, financial institution boundaries, financial functions, and regulatory responsibilities. Financial institutions can be organised in a variety of different forms, and this is of relevance to policy choice.

This paper has suggested that financial system design, including the design of regulatory policy, should take into account the potential biases induced in the organisational forms adopted by financial services firms. In aiming to achieve certain objectives, some organisational forms might be encouraged over others with deleterious effects on other social goals.

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