

**Prudential Regulation and**

**the future of**

**Australian Credit Unions**

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With the establishment in 1992 of AFIC, the level of supervision and reporting requirements for Australian credit unions have increased significantly. While the aims of AFIC, and many of its initiatives are laudable, these developments pose serious questions for the future of credit unions.

As a result, credit Unions face a choice between change or death. Disturbingly, the most likely changes may ensure the survival of current financial institutions but hasten the demise of the relevance of the principles underlying the credit union movement.

Such a result may be inevitable. Perhaps credit unions - like the dinosaur - had a place in an earlier world, but are not suited to a modern sophisticated, competitive, financial world. We should not rule that possibility out, but it is clear that, at the very least, credit unions have to adapt to the environment in which they operate (and try to improve it). The danger is that credit unions are being forced by government to adapt in ways which are not necessarily appropriate or desirable.

In what follows, I address a number of the changes occurring, the logic behind them, and scenarios for the future. Since most of the issues relate to the philosophy and goals of credit unions, it is appropriate to commence there.

#### **[1] Cooperation, Self Help, and Government Supervision**

The credit union movement was founded on the basis of cooperative endeavour and self help. Such a philosophy sits uncomfortably

with a government supervisory framework. Consider why governments might be involved:

- [a] To protect customers of the institution from exploitation - hopefully not relevant for institutions whose customers are members and whose objective is "member welfare".
- [b] To protect members from poor management - this is surely the antithesis of self-help.
- [c] To ensure members do not lose funds, since government support may be expected by the community - that community expectation does seem to exist, but is hardly compatible with the original self help motivation of credit unions.
- [d] To create an image of safety and soundness, and provide mechanisms for solvent institutions to weather financial system crises, thereby reducing the likelihood of "contagion" - relevant nowadays since credit unions are deposit taking, liquidity creating institutions, unable to insulate themselves from the remainder of the financial system.

Because credit unions have evolved into financial institutions which are (i) integrated with the rest of the financial system, and (ii) largely indistinguishable from other deposit taking institutions, they cannot escape involvement in a general supervisory framework. Going back, to a world where common bonds meant something and where members funds were truly "shares", when an argument existed for relying on self help rather than

government supervision, is not feasible. Going forward, though, the remaining differences between credit unions and other financial institutions mean that the general supervisory framework may not be particularly suitable.

## [2] AFIC and Credit Union Supervision

AFIC has introduced a number of new elements to the supervisory framework for credit unions, and rationalised previously disparate state requirements. Aspects include:

- [a] Compulsory preparation of risk management policies
- [b] Liquidity requirements
- [c] Risk weighted capital adequacy requirements
- [d] Constraints on activities and portfolio allocations

The motivation behind these requirements is, I believe, worthwhile. But it is far from apparent that the policies implemented have been appropriately tailored to meet the particular characteristics of credit unions. Some aspects are considered in following sections.

## [2] Risk Weighted Capital Requirements

AFICs capital adequacy requirements follow those adopted by the Reserve Bank of Australia (RBA) for Australian banks and internationally accepted proposals advanced by the Bank for International Settlements. As outlined by AFIC (1992, p16) "The primary role of capital in a deposit taking institution is to provide a cushion against loss and to maintain the confidence of

its depositors". In principle, shareholders (owners) are required to put funds at risk to protect depositors (customers) from loss. In practice, it is a form of protection for governments who might otherwise feel compelled to compensate depositors for loss.

The difficulty of applying this rationale for capital adequacy to cooperative institutions should be evident. There is no distinct class of shareholders separable from depositors. Thus, prudential requirements aimed at protecting depositors which are based on an assumption that such a distinction exists may be questioned. In particular, since capital reserves are the property of members, any protection reserves provide to depositing members is in the form of self insurance by the members themselves. Significant losses incurred by a credit union impact solely upon its members - a significant capital base merely leads this to be designated this as a loss of members' accumulated capital rather than as a loss of deposit funds.

It may be argued that changing the accounting for a credit union's loss has merit. Because credit union reserves (owned communally by members) rather than deposits (owned individually by members) bear the initial impact, such losses may have less psychological impact. Thus, credit union susceptibility to crises of confidence may be diminished.

That may be indeed be so - but it does not demonstrate that the scheme chosen is the best one available to achieve such an effect. The scheme chosen has particular merit where there are

separate classes of shareholders and depositors and where there are government guarantees (explicit or implied) about the safety of deposits. Neither characteristic applies to credit unions - which also put members funds at risk to support members of other credit unions under still extant stabilisation schemes. And the costs to credit unions of the chosen capital adequacy scheme are high.

### [3] The Cost of Credit Union Capital

"Permanent" capital can only be accumulated by credit unions through retained surpluses from operating activities. While notionally the property of members, ownership rights to retained surpluses are somewhat vague. Thus, members bear the cost of creation of such capital (since their transactions with the cooperative generate the operating profit), but receive ill defined benefits.

Every dollar of surplus generated and retained by the credit union, is a dollar "lost" to individual members. They do gain something -the possibility that reserves may absorb losses while they remain a member, and thus provide protection for their deposits. But the inability of members to access their contribution to the cooperative's capital if they leave the cooperative, means that this benefit is bound to be worth less than the dollar given up.

This makes the acquisition of capital a costly process for credit cooperatives. Every dollar retained at a cost to members of a dollar, is worth less than one dollar to those members. In

effect, the cooperative is "taxing" its current members, and the benefits will flow primarily to future members (who gain from the security implied by large accumulated surpluses generated prior to their membership).

One might argue that luckily for credit union managers, most members don't recognise the extent of this tax. However, while not explicitly aware, the cost is implicit in interest rate spreads. Members will react to excessive taxation by taking their loan and deposit business elsewhere - hastening the demise of credit unions. They might, if informed, support such a tax as part of their contribution to communal goals - but they should at least be made aware of the cost to them (and general benefits to members current and future) of the credit union acquiring capital.

While on this topic, it should also be noted that the cooperative nature of credit unions means that standard performance measures, such as return on capital employed, are not applicable. Since the return on these funds is from profits made from transactions with members (in general), it is not apparent that a higher return on those funds is necessarily consistent with cooperative objectives of maximising member welfare. That is particularly so when the amount of capital reserves have not been voluntarily chosen, but imposed by a government supervisor.

#### **[4] The Size of Capital Requirements**

Since capital is costly for credit unions, it is important that

any requirements imposed are not excessive. In considering this question, it should be noted that capital reserves will not be needed to protect depositor members from "normal" default rates on loans. Prudent interest rate setting will ensure that loan interest rates incorporate a margin which allows for average default experience. It is thus only the abnormal default experience which gives rise to the need for capital requirements for protection of depositor members.

What then constitutes an adequate capital requirement for coping with abnormal default experience on a portfolio of small unsecured and residential mortgage loans? Here, modelling of the distribution of default experience on such loans is required for a precise answer, but there is no doubt that the requirement of 8% is grossly excessive for personal unsecured loans. Accounting standards, for example, only require that general statutory provisions for bad and doubtful debts (both secured and unsecured) be 1% of total loan outstandings.

To provide an idea of the magnitudes involved, suppose that an institution has 100 equal size loans outstanding, and that the probability of any individual loan defaulting (in total) was 0.04. (I.e., one in twenty five loans are assumed to default entirely on average). Such default experience would contribute around 4.6 percentage points to the interest rate margin charged by the institution (on top of any allowances for operating expenses etc.). It is thus a clear overestimate of typical default experience. What is the chance that a large number of



defaults will be experienced in any year and wipe out the institution's capital base? The probability that in any year more than 10 loans would default (i.e. 6 "abnormal" defaults) is 0.0022. Thus if the institution had capital equal to 6% of assets, the probability of failure in any year would be 0.2% (i.e. once every 500 years on average).

One potential danger with the current capital requirements is that they can have adverse effects. Suppose an institution has a high number of abnormal defaults. It is then required to rebuild its capital reserves. Since this can only be achieved by increasing the interest rate margin, including charging higher loan interest rates, one consequence may be to increase the likelihood of further defaults.

#### [5] Capital Adequacy and Credit Cooperative Growth

Capital adequacy requirements imply that growth can only occur if the capital base also expands. This creates a particular problem for cooperatives, since the only source of enlarged capital is through operating surpluses (i.e. internal capital generation). Rapid growth requires large surpluses, but to achieve large surpluses deposit rates must be set relatively low and loan rates relatively high - settings which are not conducive to attracting business and growing rapidly.

In fact, capital adequacy requirements imply a limit to the natural growth rate of credit cooperatives. In contrast, other financial institutions can grow rapidly if opportunities exist

by attracting new capital from equity investors. Some idea of the implied limit on credit union growth rates can be gained from some simple calculations. The maximum growth rate for credit unions relying on internally generated capital to maintain a constant capital ratio is given by the Return on Investment (ROI). ROI can be rewritten as

$$\text{ROI} = \text{ROA} (\text{TA/NA})$$

where ROA is return on total assets. For credit unions this has typically averaged around 1% p.a. A capital requirement of 8% is equivalent to a ratio of  $\text{TA/NA} = 12.5$ . Combining we obtain an implied value for ROI of .125 or an implied growth rate of total assets of 12.5% p.a.

Complications are also created for coping with growth opportunities. For example, a cooperative with sudden natural growth opportunities will need to achieve a higher ROI to meet capital adequacy requirements. If, for example, growth opportunities exist because of growth in the common bond membership, existing members will bear the major burden (in the form of higher loan rates and lower deposit rates) of the higher ROI required to permit the extension of services to new members.

#### [6] Wealth, Protection and Control

One consequence of capital adequacy requirements is that credit unions are amassing a significant stock of wealth to which there are ill defined ownership rights. Several issues are important.

First, to whom does this belong if the credit union is wound up, or converted to an alternative form? We have recently observed the impact of conversion of several building societies from mutual to transferable share form - with enormous transfers of "members" wealth to those lucky enough to receive share allocations.

Second, if capital adequacy works as hoped by the supervisors to make depositors less concerned about deposit safety, we can expect them to take even less interest in credit union affairs than currently. If there is no monitoring of management by concerned depositors, erosion of the common bonds which may have kept managers' interests close to those of members, and no share market discipline, - what mechanisms will act to prompt efficient management? The answer is probably none - unless the supervisory authority plays a role, or unless credit unions adapt in some way to improve management oversight by members.

#### [7] Liquidity and Capital Adequacy

A particular liquidity problem arises for credit cooperatives because of their common bond restriction upon business activities. Quite marked changes in the demand for loans relative to the supply of deposits can occur because of demographic characteristics. While changes in interest rates can be used to bring demand into line with supply, an optimal strategy may be to allow imbalances to show up in swings in liquidity.

The problem created by such an approach is that liquid assets involve a markedly different risk weighting to personal loans in

the capital adequacy framework. Thus swings in liquidity will be directly related to the cooperative's capital position.

While such influences upon the capital position can be managed, the magnitude of the effect can be substantial. For example, at the time of the introduction of the capital requirements in 1992, credit cooperative liquidity averaged around 40%, compared with a more usual figure of around 20%. Assuming that liquid assets have a risk weighting of 10% and loans have an average risk weighting of 75%, a reduction in the liquidity ratio from 40 to 20 would reduce the capital ratio of a cooperative initially at 10% of risk weighted assets (of  $.1(40)+.75(60)=49$ ) to a ratio of 7.9% of risk weighted assets (of  $.1(20)+.75(80)=62$ ).

One consequence of this liquidity effect is that credit cooperatives will find it much easier to respond to shocks which increase total asset growth originating on the deposit side of the balance sheet. The extra capital requirements associated with accepting those deposits and investing them in liquid assets are relatively small. But growth in activity arising from loan demand brings with it a need for significant capital increases, and may be less easy to respond to.

#### **[8] Supervision, Scale and Survival**

One consequence of AFIC has been an increase in the amount of reporting required of management, imposing significant costs on smaller credit unions. Coming hard on the heels of a more widespread move to make directors more accountable (and liable),

the viability of smaller credit unions is undoubtedly in question.

As a political objective, a reduction in the number of small financial institutions makes sense. There are less explicit costs involved in supervision, and the problems of contagion are most likely reduced. Undoubtedly, the number of credit unions is diminishing because of mergers - and entry into the industry looks extremely unlikely.

It must be asked whether the demise of small credit unions is an unstoppable and/or desirable event, dictated by economies of scale. Personally, I doubt that economics dictates the demise of small credit unions. As long as there is an industry association which enables credit unions to operate much like (independent) branches of a large nationwide bank, most of the benefits of scale are achievable even to small credit unions.

The trend towards increased concentration, and reduced importance of common bonds, should be of concern to all who believe that the cooperative spirit still has a role to play.

#### [9] The Future

Credit Unions must adapt to survive. Given the problems outlined above, there are several possible responses.

First, credit cooperatives will seek ways of acquiring capital reserves by methods other than accumulated surpluses (perhaps

including the relinquishing of cooperative status). To the extent that this leads to creation of a specific class of equity holders in the institutions, the problem of allocating ownership rights to the existing capital in the institutions will assume major importance. It would be scandalous if the wealth built up over the years by cooperatives were to be distributed via public floats, with major capital gains accruing to those lucky enough to receive equity entitlements.

Second, credit cooperatives will have an incentive to act primarily as deposit takers and providers of associated services, investing in primarily liquid assets for which the capital requirements are minimal. This creates a problem of satisfying the requirements of the Financial Institutions (State) Act 1992 that at least 60% of assets should be in the form of financial accommodation to members. Probably that act should be scrapped, since it confuses activities and funding. Particularly in the era of securitisation, there is no necessary link between the origination of loans and their ultimate funding - as implied by that Act.

Third, credit cooperatives will have an incentive to expand common bonds to reduce the problems of managing liquidity in a world of capital adequacy requirements.

Finally, it would seem appropriate for credit unions to endeavour to find an alternative institutional form consistent with the new environment. In some respects, the solution is straightforward.

Since the main problem revolves around the lack of ownership rights attaching to accumulated surpluses, a form which provides such rights would make sense. For example, all members could be credited with a "share account" to which is credited their share of retained earnings for that year. On leaving the credit union, members would, after some qualifying period, be able to withdraw the funds in the share account. The credit cooperative would face fewer constraints in accumulating capital, would have a relatively stable (although not permanent) capital base, and would still maintain the cooperative principle as the basis of its activities.