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Australian Credit Unions and the Demutualization Agenda

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ABSTRACT

There is a strong prospect of widespread demutualization occurring in the Australian credit union industry in coming years. This paper explains the reasons for this phenomenon, identifies some potentially undesirable social consequences, and examines the relative merits of alternative types of demutualization process. It identifies a number of principles which warrant reflection in the design of legislation addressing demutualization processes.

Keywords: Demutualization; Credit Unions; Governance; Regulation

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Introduction

The future ownership structure of Australian credit unions directly affects a large proportion of the population, even though the credit union sector is relatively small, with around 2 per cent of total deposits of Australian deposit taking institutions. Around 20 per cent of the population had membership and thus (through the mutual organizational structure which has been a fundamental principle of the credit union movement) were owners of the 146 credit unions operating in late 2006.

That ownership structure is poised to undergo massive transformation, with the Australian credit union industry facing the prospect of widespread demutualization of large credit unions, as happened in the Australian building society and insurance company sectors a decade ago (RBA, 1999). As well as the direct impact on the owner member-customers of institutions which demutualize, this prospect poses major commercial and philosophical challenges to the industry associations which represent and provide financial and technical services to member credit unions.

Demutualization can be socially beneficial when it involves an efficiency enhancing change in governance and organizational structure. Where mutuals change significantly the range and nature of activities in which they engage or where membership interests become divergent and competition intensifies, a change of governance structure may be warranted (Mayers and Smith (2002), Hart and Moore (1996)). But where only a governance change occurs (unaccompanied by a change in activities), there is little evidence that efficiencies result, suggesting the possibility of other motives (Davis, 2005).

One such possible motive is wealth expropriation. Demutualization necessarily involves distributional consequences through the conversion of communal wealth into private wealth for participants in the process. Hence, it may be prompted by a motive of expropriation even if the efficiency consequences are adverse (Davis, 2001). The amounts involved are large. The communal wealth represented by the accumulated capital of the fifty largest Australian credit unions was, in aggregate, around $2.5 (USD 2) billion at mid 2006 (KPMG, 2006).

This paper argues that credit union growth and increasing financial sophistication have led to a paradoxical situation in which a mutual governance structure creates the seeds of its own destruction. This arises from the increased importance, and incentives, of professional management, and from requirements to accumulate financial capital for risk management purposes which, in larger organizations becomes of sufficient size to make expropriation activities, via demutualization, worthwhile.

On the basis of an analysis of demutualization processes, some principles are proposed which, if reflected in legislation, would reduce the likelihood of demutualization occurring due to expropriation rather than for efficiency enhancement grounds. Unfortunately, legislators and regulators, not fully appreciating the social and economic arrangements implicit within the mutual structure, appear poised to introduce regulatory changes likely to facilitate expropriation.

Section 1 of this paper reviews the concepts of mutuality and demutualization. Section 2 provides background information on the recent development and structure of the Australian credit union sector highlighting the recent growth of interest in, and experience with, demutualization. Section 3 outlines the argument that credit union

evolution has a bias towards demutualization and examines some of the specific factors which have prompted the recent upsurge of interest in demutualization in Australian credit unions and which underpin the prediction that a wave of demutualization is about to occur in the Australian credit union movement.

Demutualization is premised on the argument that a change in organizational structure will increase economic value and involves allocating that value between stakeholders. Hence it is necessary to be able to calculate the mutual's value and how that might be affected by demutualization. This is discussed in Section 4.

Section 5 considers alternative demutualization methods in more detail and illustrates the particular difficulties associated with several such methods. In doing so, it addresses the tricky question of to whom the mutual's value "belongs", and thus raises the difficult moral issue of the right of current members to convert the communal wealth of the credit union into private wealth via demutualization.

Section 6 proposes a number of principles arising from the preceding arguments which warrant consideration for implementation in legislation addressing demutualization processes. [1]

Section 7 concludes with some observations for the implications for the credit union movement of the anticipated demutualization trend.

1. Mutual Characteristics and Demutualization Processes

Credit Unions are mutual organizations owned by their members, who are also their (principal) customers. Individuals can become members of the credit union if they satisfy

[1] Recent studies which have considered the merits of alternative demutualization processes include Wilcox (2006) in the case of the USA, and APPGBSFM (2006) in the UK..

some common bond of association, although common bonds of many Australian credit Unions have been broadened to be effectively meaningless. Owner-members each hold one (non-transferable, redeemable) share of nominal value and are entitled to one vote.

The mutual's objective is the, often imprecise, one of providing maximum benefit to members. Any annual surplus (profit) arising from the mutual's activities may be returned to the member owners (perhaps as a rebate of interest on loans or additional interest payment on deposits in the case of a financial mutual such as a credit union), or retained to build up a capital base of "shareholders funds". Members have no individual claim on that capital base, but may be entitled to some (generally imprecisely defined) share of it if the mutual is wound up or demutualized.

Past members (living or dead), who have relinquished their shareholding, have no formal entitlement to the accumulated wealth represented by the credit union's shareholders funds and franchise value. But, arguably, underpinning the existence of the credit union (and the willingness of departing members to forgo any claim on that wealth – to which their participation has contributed) is an implicit intergenerational contract, suggesting that future members have an implicit entitlement. Current members benefit from the economic and social capital built up and vested to them by past members who, it can be argued, expected that current members will pass on those valuable assets for use by future members of the community defined by the common bond. Rarely, however, do constitutions of such organizations explicitly outline such an objective, prescribe mechanisms for determining whether the arrangements still retain sufficient social value to warrant their perpetuation, or document comprehensive rules for termination of the arrangements.

Demutualization involves the conversion of a mutual organization into a joint stock company. This may involve issue of transferable shares in the transformed entity to members or outsiders, or issue of shares in a different entity if demutualization occurs by way of a merger with, or a takeover by, an existing joint stock company.

Demutualization changes the governance and ownership form of the organization in several ways. (WOCCU, 2000, provides more details). The former concordance of owners and customers is removed. The new owners have transferable, non-redeemable, shares (generally listed on a stock exchange) which entitle them to a claim on the wealth of the company, and voting rights, both proportional to their shareholding. The principal objective of the company becomes (in principle at least) the maximization of shareholder wealth.

For demutualization to occur, the members of the mutual must vote for a scheme of arrangement in which their ownership entitlements are replaced by a new form of ownership involving tradable shares each with a pro rata claim on the wealth of the company and pro rata voting rights. There are three main ways (analyzed in detail in Section 5) in which that could occur. These include: a "pure" demutualization where shares are allocated free of charge to members (or others); demutualization involving a capital raising by subscription for new shares (perhaps accompanied by some allocation of free shares); members receiving or subscribing for shares in a non mutual joint-stock company which takes over or merges with the mutual. This taxonomy, based on possibilities available under Australian legislation, provides a useful framework for

analyzing issues associated with demutualization and the design of public policy both in Australia and elsewhere.[2]

2. The Australian Credit Union Industry Experience

Table 1 provides some background information on the evolution of the Australian credit union industry over the past decade. The number of credit unions (which peaked prior to the starting date of Table 1 at 833 in 1974) has continuously fallen due to ongoing merger activity. The increasing concentration of the industry is apparent, with the asset share of the largest ten credit unions increasing from almost 25 per cent in 1995 to over 50 per cent in 2006.

Although aggregate membership data for recent years is not available, industry sources suggest that membership has remained relatively constant. Asset growth has been comparable to, although slightly less than that of other deposit-taking institutions, but any comparison of changing relative importance in retail financial markets is confounded by the increased securitization of housing loans (both by credit unions and others). As well as increased use of securitization, the majority of credit union on-balance sheet assets are now housing mortgage loans.

Heightened competition from banks in a deregulated financial market is one factor contributing to the exit (via merger) of many small credit unions over the past decade. But also important has been the effect of legislation and regulation (summarized in Table 2). Risk weighted capital requirements were introduced in the early 1990s, and

[2] In the USA, public policy changed in 1974 from requiring a “free distribution” (pure demutualization) model to a “standard conversion” (subscription) model. Wilcox (2006, section IIIB) provides more details. Demutualization via merger/takeover does not appear to be permitted, and credit union demutualization is a two stage process involving a prior step of conversion to a mutual savings bank..

accompanied by increased regulatory oversight and pressure on credit unions with weak

Table 1: Australian Credit Union Trends

Date	Number of Credit Unions[a]	Mergers in past year	Total Assets ($bill)	Total Assets of Largest Ten ($bill)	Members (mill)
Jun-95	291	12	13.9	3.8	3.24
Jun-96	282	9	15.4	4.3	3.32
Jun-97	269	13	16.8	4.8	3.46
Jun-98	244	25	18.2	5.9	3.44
Jun-99	222	19	20.0	6.8	3.51
Jun-00	215	8	21.5	7.9	3.58
Jun-01	205	9	23.9	8.5	3.57
Jun-02	196	7	25.5	9.9	n.a
Jun-03	187	10	28.5	12.0	n.a
Jun-04	177	10	31.1	13.3	n.a
Jun-05	164	12	33.1	15.4	n.a
Jun-06	148	14	35.7	19.3	n.a

(a)The annual change in the number of credit unions differs slightly from the number of mergers due to some multi-credit union mergers and a very small number of liquidations.

Source: APRA, CUSCAL, KPMG

capital positions to accumulate capital or merge with stronger partners. In 1993, credit unions lost their tax-exempt status and were subjected to company tax which, because of their inability to distribute to members the tax credits arising under Australia's dividend imputation tax system, placed them at a competitive disadvantage to non-mutual organizations. In 1999, the application of the Corporations Act to credit unions (replacing special cooperatives legislation), imposed additional reporting and compliance requirements on credit unions. This also created the potential for hostile takeovers and for constitutional changes to inadvertently open the way for demutualization. The latter issue was partially resolved by issuance of a statement on the matter by ASIC, but the potential for hostile takeovers, which involve demutualization, remains.

In 2001 the Financial Services Reform Act was passed imposing additional licensing and training requirements upon credit unions. In 2006 APRA introduced new standards for governance arrangements and director "fit and proper" requirements, imposing further compliance duties and responsibilities upon boards of financial institutions.

The cumulative effect of these changes has been to increase operating costs for small credit unions and demands upon volunteer directors. In many cases those directors have decided that mergers to create (or join) a larger organization able to achieve scale economies and remunerate directors is the preferred strategy.

Table 2: Key Regulatory and Tax Changes

Date	Event
1992	Creation of national regulator, AFIC, to replace state supervisory bodies
1992 (October)	Imposition of Risk Weighted Capital Requirements
1993	Budget Announcement of Taxation of Credit Unions – commenced (phased in) 1994, fully complete 1997.
July 1, 1999	Credit Unions made subject to Corporations Act (administered by ASIC) rather than special (state-based) cooperatives legislation
July 1, 1999	Transfer of Credit Union Regulation to newly created supervisory authority, APRA. Activities made subject to the Banking Act
September 2000	ASIC Policy Statement 147 interpreting mutuality and demutualization actions
September 2001	Financial Services Reform Act (administered by ASIC) introduced requiring licensing and training requirements for providers of financial services
2006	APRA introduces new governance and director "fit and proper" requirements (APS 510 an APS 520) for financial institutions

Interest in demutualization of credit unions in Australia has existed for some time, although there have been only two completed and three failed or putative attempts as at end 2006.

In 1997, the demutualization of Sunstate, a Queensland credit union, by takeover by First Provincial Building Society created much consternation in the industry, and led to an unsuccessful court challenge. Most members of the credit union received no benefits from the demutualization, despite the credit union having accumulated capital wealth of approximately $400 per member. Mathews (2000) and Davis (2005) provide more details.

In September 2003, a proposed demutualization of Connect Credit Union which offered members shares worth approximately $500 in conjunction with a capital raising, was rejected by members. Robb and Crombie (2006) provide more details. Also in 2003, a proposed credit union merger (between Australian National Credit Union and City Coast Credit Union) was impeded, but not ultimately prevented, by an attempted merger counter-offer by a building society which if successful may have resulted in a demutualization of City Coast.

In August 2005, a proposed merger of the large StateWest Credit Union and Home Building Society was announced, which would result in members of State West receiving shares in the merged entity with an estimated value at that time of $1,300 per member. (SWCS, 2005) This demutualization was eventually approved by the members (The Age, 2006). Subsequently, the merged entity made a takeover-demutualization proposal for the Police and Nurses Credit Society, which was rejected (PNCS, 2006). Reacting to this unwanted overture, the members of the credit union, passed an amendment to its constitution, imposing a minimum membership period for participation in the returns from any demutualization, thus hoping to "stop carpetbaggers from influencing the future of their credit union" (Abacus, 2006).

Also in 2005 (unwanted) overtures were made by Mackay Building Society towards Capricornia Credit Union. While no formal offer had been made (at the time of writing) the Building Society had indicated its intention to make an offer to members of Capricornia for their shares in the mutual. To do that, it had demanded, under the provisions of the Corporations Act, access to the mutual's share register (which because of the mutual structure is also its customer list). Approval of that demand by the corporate regulator is under challenge in the courts, with many predicting that it will, if supported, lead to a major shake-up of the credit union industry via hostile takeover-demutualizations (Oldfield, 2007).

Lobbying of politicians and bureaucrats by industry associations representing mutual financial institutions (credit unions, friendly societies and building societies) has led to a Treasury proposal for access to member registers to be made by way of a mailing house option, which would prevent competitors from being able to target the mutual's customer base, but which would not prevent the distribution of take-over related material.

This experience highlights a problem created by the application of laws to institutional organizational forms for which they are not suited. In 1999, Australian credit unions were made subject to the Corporations Act, requiring a company structure, rather than being subject to specific legislation designed for cooperatives and mutuals. The provisions of that Act relating to access to share registries and process for transfer of engagements on an involuntary basis, have been argued by Ralston and Beale (2002) as creating particular difficulties for mutual organizations.

Reflecting these developments, demutualization has featured regularly, since the start of the millennium, on the agenda of Australian (and international) credit union conferences,

and the main industry association CUSCAL has had a member only web site section dedicated to the issue. Notably, some leaders of the credit union movement have expressed a willingness to countenance the possibility of a non-mutual credit union, which would involve a reversal of previously accepted core principles of the credit union movement.

3. Drivers of Change

The preceding discussion suggests that Australian Credit Unions are poised on the brink of a demutualization wave, similar to that which has previously occurred in the Building Society and Insurance sectors in Australia (RBA, 1999).[3] That reflects both inherent forces in the longer run process of credit union development which make the industry susceptible to an outcome of demutualization, together with some shorter term specific factors.

The long run drivers of this prospective demutualization process are two fold. One is the accumulation of significant concentrations of communal wealth in the form of credit union capital reserves which can, via demutualization, be converted into private wealth. Connect Credit Union, for example, had approximately $35 million in accumulated reserves (net assets). At June 2006, 17 credit unions each had capital bases in excess of $50 million (KPMG, 2006). In addition to this "book value" wealth, the potential market value of the entities is significantly higher because of their franchise value, which reflects both their market position as established providers of financial services and their

[3] A list of demutualizations in Australia since 1985 can also be found at http://www.delisted.com.au/Demutualised.aspx .

opportunities for future growth. Both outsiders and insiders, possibly prompted by investment bank advisors seeking fee income, may perceive the opportunity to expropriate a significant share of that communal wealth for their personal benefit through the demutualization process.

A second long run driver has been the (necessary) emergence in the modern, technologically advanced, competitive financial system of professional managers of credit unions. Managerial objectives and ambitions play a key role in shaping the strategic agenda of such mutual organizations where the one member – one vote rule means that which member "voice" is relatively muted. One consequence, reinforced by the existence of economies of scale (at least up to some size) is a focus on growth, size, and profitability as measures of performance. Larger sized organizations (often due to mergers) have larger pools of accumulated communal wealth, making it worthwhile for opportunistic investors to encourage demutualization and capture a (perhaps excessive) share of the communal wealth.

A second consequence of managerial objectives and ambitions is a view of a desirable future for their institutions as something more than the unsophisticated retail financial institutions of credit union history. The potential result is expansion into areas of activity (requiring greater reliance on, exposure to, and oversight of, managerial decision-making) for which the mutual form of governance may not be particularly suited. Growth ambitions are also impeded by the inability of mutuals to generate equity capital (to meet

regulatory requirements and/or for prudent risk management purposes) other than by profit generation and retention.[4]

This suggests that credit union "success" sows the seeds of its own destruction. Professional managers are required to provide expertise and manage risks. However, their personal ambitions are constrained by growth limitations imposed by the mutual structure, and by the limited range of traditional credit union activities. Because the mutual form gives managers a significant degree of entrenchment and autonomy (Rasmusen, 1988), they are able to pursue changes in the range of activities to include those not suited to a mutual form of governance. Achieving growth requires capital accumulation at the expense of current members (because terms and conditions on services provided become less favorable in order to generate profits and thus capital) and generates a larger pool of communal wealth ripe for expropriation.

Professional managers may initiate the demutualization agenda, although external forces and, sometimes member influence, also play a role. While demutualization may remove the advantage and benefits of managerial entrenchment (remuneration and perquisites) which the mutual form provides, this is offset by the potential for substantial windfall gains through the allocation of entitlements to demutualization proceeds.

In the shorter term, a number of interrelated events have brought the focus directly upon demutualization and are likely to prompt the widespread demutualization forecast above.

One such factor is concerns of credit union management about potential hostile takeovers. This appears to be leading to a view that voluntary demutualization is a lesser

[4]In 2006, however, a group of Australian credit unions were able to develop and issue a preference share instrument (compatible with their mutual status) which can be used to raise external funds to help meet regulatory capital requirements (ABN AMRO, 2006).

evil, because it ensures that members rather than outsiders gain the private financial benefits of demutualization. Although this argument hinges upon the assumption that the credit union leadership cannot induce members to reject a takeover on terms which do not reflect the full credit union value, it will be argued below that the assumption may well be warranted.

A second factor is the effect of example. Publicity about the size of private financial benefits accruing to those members participating in demutualizations of other credit unions can lead to member pressure for demutualization to generate similar private benefits, and induce otherwise ambivalent management into pursuing such a course of action. This is more likely to be the case when common bonds have been widened (partly in response to managerial growth ambitions) to such an extent that there is little affinity between the member and the credit union and the relationship is more like that of a pure customer than a member.

Compounding these forces has been the effect of regulation, initially designed for a different organizational form of financial institution, and which has also contributed towards mergers into larger organizations where size is large enough to justify the transactions costs associated with demutualization. These regulations include minimum capital requirements (which enforce the accumulation of communal wealth), the effects of which are analyzed by Greinke (2005), and more stringent requirements for governance arrangements and compliance (which impose significant costs on smaller organizations).

Finally, the sector’s leadership has been placed on the horns of a dilemma by the perceived inconsistency between commercial reality and continuance of long standing

commitment to mutuality as a core feature of credit unions. The peak industry body (CUSCAL)[5] serves a role as both a supplier of central banking and other commercial services to credit unions, as well as being a trade association and industry lobby group. (The other (smaller) industry body, CreditLink[6], provides similar services and both organizations have the ability to provide services to non-mutual organizations). Should the demutualization of large credit unions require that they no longer source commercial services, nor pay membership fees, the scale of the industry peak body will need to reduce. That is likely to be commercially undesirable to the leaders of the industry body, and if downsizing involves loss of economies of scale in providing those services, the remaining industry members will be faced with higher costs. One result has been a willingness to entertain the notion of a non-mutual credit union, so as to avoid these costs, but at the expense of embracing a new (albeit unrationalized) philosophy which makes demutualization more likely.

4. Demutualization and Credit Union Value

Demutualization has a number of valuation (wealth) effects. First, there is the conversion of the communal wealth represented by the credit union's "value" into private wealth which is distributed to members (and possibly others). Second, there is the possibility that the change of governance and ownership structure of itself affects the value of the organization, if the mutual structure is not an optimal organizational form for the activities being undertaken (Mayers and Smith (2002), Hart and Moore (1996)). Third, demutualization may be accompanied by a change in activities (such as applying acquired skills and knowledge to new products better suited to provision by non-mutuals) which

[5] See http://www.cuscal.com.au for background information
[6] See http://www.creditlink.com.au/home/default.asp for more details

have value creating effects. It is, of course, possible that expansion into those products has already occurred prior to demutualization.

The "value" of a mutual organization *post demutualization* may thus differ from that *pre demutualization*. Post demutualization, the existence of a defined group of owner-shareholders with tradable equity stakes in the entity mean that sharemarket value of equity can be used as a measure of value (for that group) and its maximization provides a clear objective for management. (The social value of the entity may differ if, for example, its actions create uncompensated negative or positive externalities for society, or if it chooses to divert part of potential shareholder wealth into charitable, communal, benefits).

Pre demutualization, the objective function of a credit union is somewhat more opaque, and involves creation of net benefits for the community from which it draws its members. Consequently, it is potentially quite difficult to estimate the "value" of the mutual organization which is necessary for comparison with an expected post-demutualization value as a justification for demutualization.

Indeed there are two potential pre-demutualization concepts of value warranting consideration. One is the purely private-interest valuation to current members as owners. The second is the social valuation reflecting the total set of activities of the credit union which may involve communal benefits (to both current and future generations) not captured in a purely private-interest valuation.

In considering the private interest valuation, two questions warrant consideration. First, do typical indicators of shareholder value provide accurate signals of the entity's current

worth. Second, how might the ability to create value for owners change with demutualization.

Regarding current value, accounting earnings may be lower than for a similar non-mutual organization for a number of reasons. These include costly provision of better terms and service to member-customers consistent with a non-profit orientation, specific financial or resource contributions to the community being served, and possibly greater focus on corporate social responsibility issues. Demutualization may thus lead to higher earnings because of a profit focus, but this represents primarily a transfer of value from previous recipients of these benefits, rather than a net increase in value. Alternatively, lower earnings of the mutual could reflect inefficient management and thus higher costs due to inferior governance arrangements and lack of equity market pressure which demutualization might correct.

But it may also be that there are sources of comparative advantage arising from a mutual structure *per se* which give it a higher value than an equivalent non-mutual organization, and which may be lost with demutualization. One source is direct financial benefits for members arising from an ability of a mutual organization to operate more efficiently than competitors offering similar services. Better information about member-customers may be a source of comparative advantage, as may be lower customer concerns about exploitation or risk resulting from the absence of owner-depositor agency problems and the convergence of organizational and member objectives. Whether large mutual organizations operating under the purview of a prudential regulator still possess such informational and safety advantages, and with professional management defining and

pursuing their preferred organizational objectives, different to member objectives, is open to question. (Rasmusen, 1988)

Benefits may also arise from the endowment of capital provided by way of accumulated past surpluses, which provides a source of finance for current borrowing members and a protective loss-absorbing buffer for depositors. The rate of return required on these funds may differ from that which would be demanded by equity holders in a non-mutual, although Miles (1994) argues that these required rates of return should be equal. However, when growth and the need for accumulation of capital to maintain a constant capital ratio is low, credit unions would appear to have an advantage because of the concordance of owners and members. Required return on capital can be provided to current members as a direct private benefit, by way of better terms on services provided, rather than through accumulating profits over which members have an ill defined claim and which they may thus value less than the direct benefits received from service provision.

In addition to the direct financial benefits to current individual members is the possibility of social "value" arising from the mutual form. The institution is a form of "social capital" which may provide non-financial benefits for members and the community. Benefits from the mutual governance structure may arise because of the greater management discretion which exists, and the absence of a profit focus. Mutuals may be better able to operate in ways that are consistent with a social conscience and adopt non-commercial goals, given that they have communal benefits as their *raison d'être*. The mutual governance structure gives managerial flexibility to identify an appropriate mix of communal benefits and pursue them.

In practice there is a better chance of good outcomes from this process when the community served is relatively well delineated and common communal goals can be identified. Similarly, the ability to pursue such non-communal goals is weakened when members are essentially customers, who respond to competitive prices from other suppliers, rather than member-owners exhibiting loyalty to the organization. This suggests that the growth and widening of common bonds of many credit unions has reduced this social value characteristic significantly.

Even if any attempt to measure social value is eschewed, valuation of private benefits of ownership and how these might change with demutualization is a difficult task. Some items, such as the change in the potential earnings stream arising from a shift to a profit focus may be estimated. However, earnings are generated by applying both the financial capital of the institution together with reliance upon its franchise value. While financial capital (net tangible assets) can be readily calculated, franchise value is hard to estimate. Moreover, the extent to which franchise value might be altered by changes in loyalty arising from the separation of owners and customers due to demutualization is hard to assess. These difficulties in estimating value generate significant risks of inappropriate transfers of value in the demutualization process[7], which are addressed in the following section.

5. Demutualization Methods and Member Rights

A number of alternative methods exist for undertaking a demutualization of which the following three are most common.

[7] This problem has been examined in the UK by a recent Parliamentary Report, APPGSBM (2006).

In a **Pure Distribution** approach, existing members are allocated tradable shares free of charge according to some rule. This could involve all current members receiving an equal number of shares or a number which is related to years of membership or some assessed value of the past business relationship with the mutual.

For example, consider a mutual with 10,000 members, each with a redeemable value of $1, and with accumulated shareholder's funds, from past activities, of $10 million. A pure demutualization might involve each member receiving 100 tradable shares each with a net asset (book) value of $10. Those shares might commence trading on the stock exchange at $20 each, with the market value exceeding book value because of the *franchise value* of the organization. In the pure distribution approach current members receive as private wealth the entire value of the mutual, including any gains (or losses) reflected in the stock price arising from anticipated changes in efficiency due to demutualization.

In a **Subscription** approach tradable shares are sold to applicants, who may be non-members as well as to members of the mutual. Members may be eligible for some allocation of shares at a zero or subsidized price, and may have priority subscription rights – such that non-members will only participate if there is inadequate member demand. Using the example considered above, the mutual may allocate 100 free shares to each member (1 million in total) and invite subscriptions from members and non-members for an additional 1 million shares at a subscription price of $12.00. With the additional $12 million of subscriptions, shareholders funds will now be $22 million, so that the net asset (book) value of each of the 2 million shares on issue is $11. Note that the (non-member) subscribers have made an immediate gain (in book and, most likely,

market value terms) because they capture some part of the pre-existing wealth of the mutual.

In a **Merger/Takeover**, a non-mutual acquirer allocates or sells shares in itself to members of the mutual in exchange for their relinquishing ownership of the mutual. Continuing the example used above, suppose the acquirer has 10 million shares on issue which have a book value of, and also trade at, $10 each (ie $100 million in aggregate). Assume that it offers 50 new shares in itself to each of the mutual's 10,000 members. (Note, for later reference, that this is an offer with a total pre-merger value of $5 million in exchange for acquisition of the mutual which has a book value of $10 million). If the mutual's members agree, the combined entity will have 10.5 million shares on issue and net asset (book) value of $110 million. Each share now has a net asset value of $10.48, and original owners of the acquirer have gained in book (and most likely market value) terms by capturing some part of the pre-existing wealth of the mutual.

Demutualization involves a number of practical problems, including the determination of how shares should be allocated to members. But another problem illustrated above is created by the use of subscription or merger/takeover methods. This problem results from the fact that the mutual organization has a "market value" which is unknown pre demutualization. This value may be some multiple of net tangible assets (shareholders funds), perhaps as much as 3 to 4 times, depending on the *franchise value* of the organization.

The **pure distribution** does not require estimation of the market value of the mutual for its implementation, and all of the value goes to current members (or other stakeholders

recognized as having some entitlement). The major complication is in determining a "fair" distribution of entitlements to shares between members.

The **subscription** approach requires estimation of market value, in order to set a subscription price. In principle, it is possible to set the subscription price, in conjunction with an allocation of free shares to members such that the post demutualization share price equals the subscription price and members thus receive the entire value of the mutual. However, assessing the correct subscription price is problematic, particularly because there is no pre-demutualization market valuation of the mutual available to provide guidance. The risk exists that outsiders who subscribe for shares will get an inappropriate share of the value at the expense of members, as illustrated in the example above. (See also Colantuoni (1998) for a discussion in the US context.)

Even if there are no outsider subscribers, the subscription approach has the potential for privileged insiders to extract a disproportionate share of the organization's total value. If applications for subscribed shares exceed the number offered, some rationing mechanism must be applied. Even if proportional scaling back is to be applied, insiders who are aware that the subscription price is significantly below the true value can scale up their applications to offset that effect.

The **merger** approach also requires estimation of the value of the mutual, and of supposed "synergy" benefits and value of the combined entity. Again, as illustrated above, the risk exists that owners of the acquirer get an inappropriate share of the mutual's value at the expense of the members.

The merger example used above also raises a major problem associated with the voting processes involved in a demutualization. In that example the merger proposal would be

successful only if the members voted to approve a transaction in which they received in aggregate $5 million for assets with a total value of $10 million. Unfortunately, in practice, such collective value destruction is quite likely for the following simple reason.

In its mutual form, member-owners have no direct private claim on the organization's assets and hence will impute a private value of their pro rata share of the communal value which involves a significant discount. For example, a member planning to leave the mutual may regard their ownership stake as having a private value of zero. In this regard, it is likely that many member/customers of large credit unions with virtually open membership are not even cognizant of their ownership position. The demutualization proposal offers a direct personal financial gain, on terms proposed by management (or an external acquirer of the credit union), if a majority votes in favor. This gain could be well below the pro rata share of communal wealth, but still in excess of the member's personally imputed private value, and thus lead to a vote in favour of collective value destruction.

While it might be argued that self interest would lead to members rejecting proposals which involve collective value destruction in favour of proposals which offer better terms, there is, unfortunately, rarely a market in alternative demutualization proposals. Confronted with a yes or no choice, on terms proposed by management and/or outsiders, and unaware of alternative possibilities, members may vote in favor of a specific demutualization proposal which would be dominated by a non-proposed alternative. More generally, members are unlikely to have good information about the true market value of the organization to assess whether the proposal is fair and reasonable. In addition, the open membership of the organization means that an alternative future

demutualization proposal might involve smaller private benefits if the prospect of such proposals emerging leads to an expansion in membership through others seeking to participate (Baker and Thompson, 2000).

A more fundamental difficulty exists in determining, morally if not legally, who has "ownership" rights to the wealth which the credit union represents. First is the relevant group of stakeholders past, current or potential members? Accumulated shareholder funds have arisen partly because of the activities of previous members, who have participated in the mutual's activities and implicitly bequeathed that net wealth to all future generations of future members. Second, the mutual has generally been established to serve a particular community associated with the common bond, and that community may have as good a moral claim as do current members on the wealth accumulated from past involvement of community members? Third, sponsors (such as employers) who have provided free or subsidised services to the mutual over the years, with the implicit expectation that the mutual would continue to provide services to future generations may have a claim. Fourth, government may have a claim due to the value of implicit protection provided by explicit or implicit guarantees over member deposits or because of past tax exemptions (Barth, Brumbaugh and Kleidon, 1994).

6. Some Demutualization Principles

Governments in many countries have imposed legislative requirements prescribing acceptable demutualization processes, but increasing interest in demutualization by opportunistic investors suggests that these warrant further examination to ensure that demutualization decisions are made on efficiency grounds, reflecting social rather than

private cost-benefit calculations, rather than on wealth expropriation grounds.[8] In line with this objective, the preceding discussion suggests several principles which should apply if a demutualization is to occur. There would seem to be a case for imposing them by legislation given the imperfections in the voting processes outlined above which create opportunities for wealth expropriation and socially sub-optimal demutualizations.[9]

The First Demutualization Principle is that if a demutualization occurs, all the extant value belongs to, and should accrue to the membership and/or other appropriate stakeholders for whom the organization was created to benefit. Since the current membership did not, in general, contribute all of the value, nor did they purchase it in order to gain membership, their moral right to convert all of it into private wealth accruing to themselves would seem to be far from watertight. A wider group of stakeholder beneficiaries, including the community for which the mutual was established to serve, is perhaps implied.[10]

The second Demutualization Principle is that because valuation of the mutual is complex, demutualization should be of the “pure” type. Only in this way can it be ensured that all of the value of the mutual accrues to the stakeholder group (however defined).

The apparent difficulty with this principle is that proponents of demutualization will often claim that one of the motivations for demutualization is to raise external capital or to

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[8] Wilcox (2006) provides details of allowable processes in the USA for credit unions to change organizational form, and makes suggestions for desirable changes. APPGBSFM (2006) provides some suggestions for change in the UK.

[9] The proposals which follow would not, by themselves, prevent expropriation-induced voting by members to change a credit union’s constitution to enable a demutualization or to adopt a scheme of arrangement to demutualize by way of a merger, but would act to reduce incentives to do so.

[10] In the UK several mutuals have introduced charitable assignment clauses to prevent new members from benefiting financially from a demutualization. This reduces incentives for opportunistic investors to join the mutual and campaign for demutualization, but may also have the effect of aligning the distribution of demutualization benefits more closely with the community which the mutual was established to serve.

effect a merger in order to achieve economies or provide better services. However, both of these motives can be achieved independently of the demutualization process. Capital raisings can occur subsequently, after the stock market has established the value of shares. Legislative provisions, allowing a post-demutualization capital raising (foreshadowed prior to the demutualization) based only on an update to the demutualization information document would make additional costs small and prevent unwanted value transfers which might otherwise occur.

Takeovers/mergers can also occur subsequently, after the market has established the value of shares in the demutualized entity. While there will undoubtedly be additional legal costs of two transactions (demutualization and merger) rather than one omnibus transaction, this may be less costly for members than the value lost due to gains of external subscribers or acquirer shareholders in "non-pure" demutualizations.

De-linking of demutualization and takeover/merger, clearly limits the ability of "outsiders" to initiate a demutualization through an offer to members, and potentially increases their exposure to competitive takeover bids post demutualization. Such a de-linking would appear to be at variance with official thinking based on a view of capital market discipline (through takeovers) as desirable for efficiency and governance reasons. However, the case for hostile takeovers being the appropriate mechanism for inducing a member-owned organization to change its constitutional and governance structure is yet to be made.[11] Once such a change is made, then capital market pressures can operate.

[11] Unlike takeovers of joint stock companies where shareholders exchange an asset (shares in the target) which is part of their private wealth for cash or shares in the acquirer of greater value, the takeover of a mutual involves shareholders receiving private wealth in exchange for voting for the destruction of communal wealth to which they may attribute a discounted private value because their entitlements are generally ill-defined.

The third Demutualization Principle is that a case may exist for a "supermajority" voting rule for demutualization. Because the entity is a social construct involving intergenerational relationships, and because the social value of the ongoing mutual may (if the mutual organizational form adds value) exceed the sum of private values from demutualization, a simple majority rule may see decisions made which are socially suboptimal. In essence, there is a social benefit handed on from generation to generation which any generation can expropriate for private benefit at a net cost to all future generations – who are not explicitly represented in the voting process. Many credit union constitutions already incorporate such a supermajority requirement.[12]

The fourth Demutualization Principle is that credit union constitutions should also specify more precisely the allocation of rights to accumulated wealth should demutualization occur. Managerial discretion to determine the allocation does not seem appropriate. To encourage voting decisions which reflect social efficiency rather than private self interest grounds, and reflecting the fact that those entitled to vote were not responsible for all of the creation of social value represented by the credit union, there is perhaps an argument for constitutions providing that in the event of a demutualization a substantial portion of the credit union value will go to some agreed worthy recipient (charity, community, government) who has no voting entitlements.

Finally, an objective of ensuring that the efficiency benefits from a governance change which motivate demutualization actually occur, underpins the Fifth Demutualization Principle. That principle is that legislators and regulators should not allow any special restricted voting rights to operate for any period after the demutualization, because these

[12] An alternative approach which has been adopted by some UK mutuals is to impose a minimum membership period before voting rights are acquired.

will typically enable entrenchment of management and protection from capital market forces. Unfortunately, Australian experience to date is that demutualization has often been accompanied by agreement by regulators for a period of restricted voting arrangements which protect incumbent management.

7. Conclusion

Adherence to the credit union movement's longstanding principles would mean that demutualized institutions would no longer be regarded as credit unions and not be able to be members of the industry bodies which represent and provide various financial and technical services to members on a fee for service basis. The decimation of their ranks would reduce the ability of the industry bodies to exert political influence and draw on economies of scale to provide necessary services for smaller members.

One response, aimed at maintaining the benefits of economies of scale, could be for industry bodies to continue to offer services to the demutualized institutions as customers, rather than as members, on a fee for service basis. However, the smaller membership base, together with the possibility that former credit unions source such services elsewhere, including in-house, implies a significant shrinkage in the scale and influence of the industry associations.

Another response, reflecting incentives of industry leaders, is the problematic redefinition of a credit union to include non-mutual organizations. This would involve a fundamental change in the principles under which the credit union movement has operated since it was first founded. Of course, principles and practices do not always converge, and it can be argued that many large credit unions have operated much as if they were "for profit"

organizations, reflecting the ambitions of dominant professional managers for growth and accumulation of profits.

Demutualization of some large credit unions, where the mutual form retains few advantages and where competition and managerial objectives lead to a profit orientation, may be more a matter of form than substance. But there are undoubtedly many cases where that is not so, and where expropriation rather than efficiency motives might drive a change. Incorporating into legislation principles such as those set out in this paper would work towards reducing the likelihood of such undesirable outcomes.

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