Is a competitive banking fifth pillar feasible?

In 2010 the Treasurer Wayne Swan was promoting the possibility of the mutual ADI sector (credit unions, building societies and, now, mutual banks) to emerge as a competitive counterweight to the large banks. It hasn't yet happened as the slow growth of the sector (averaging around 6 per cent p.a.) shown in the figure indicates.

But can the mutuals seize the opportunity provided by the tarnishing of major bank reputations from the Royal Commission and the recent ACCC Report to grow and provide a fifth banking pillar? One which would be competitive and not driven by profit seeking, with customers also being the owners.

Unfortunately, unless there are radical changes in regulation and regulatory attitudes, the answer is no. Mutuals are hamstrung by being subject to regulatory capital requirements designed to apply to for-profit-banks, but which are not suited to mutuals.

What is the problem? With such capital requirements, growth requires accumulation of regulatory capital. Mutuals have not been able to raise such capital externally and could only generate capital by making and retaining profits. As the figure shows, mutuals have had a low rate of profit (ROE) of around 6 per cent – well below that of the major banks.

But more profit comes at the expense of member-customers (via higher loan interest rates, lower deposit rates, higher fees). This is antithetical to the objectives of mutuals to provide benefits to member-customers, and would reduce their attractiveness to those wanting to flee from the large banks.

So attempting to grow from internal generation of profits doesn't make sense. Maybe there is hope, though from recent regulatory approval for mutuals to make limited issues of Mutual Equity Interests (MEIs), a form of preference share which can count as regulatory capital?

Unfortunately not. Potential investors in MEIs will want a rate of return of over 6 per cent (franked) judging by the yields paid by banks on their preference shares. But most of the mutuals have a ROE of 6 per cent or lower.

It makes no sense to raise capital by issuing MEIs where the return given to the investors exceeds the return which can be generated from using those funds. Maybe mutuals could increase their ROE to make issuing MEIs economically viable – but making higher profits is at the expense of their current members! This is not a strategy consistent with their mission.

What can be done to overcome the regulatory capital roadblock?

One possibility is demutualisation into profit-oriented firms with shareholders, which would enable access to external capital. Apart from being inconsistent with their mission and, I would argue, ethically fraught, the history of past demutualisations indicates caution. Most demutualised financial firms have ultimately been swallowed up in takeovers by the big banks and other financial institutions. No long run competitive benefits there!

Radical regulatory changes warrant consideration to facilitate increased competition without degrading prudential standards. These must involve finding alternatives to the current regulatory capital requirements for mutuals.

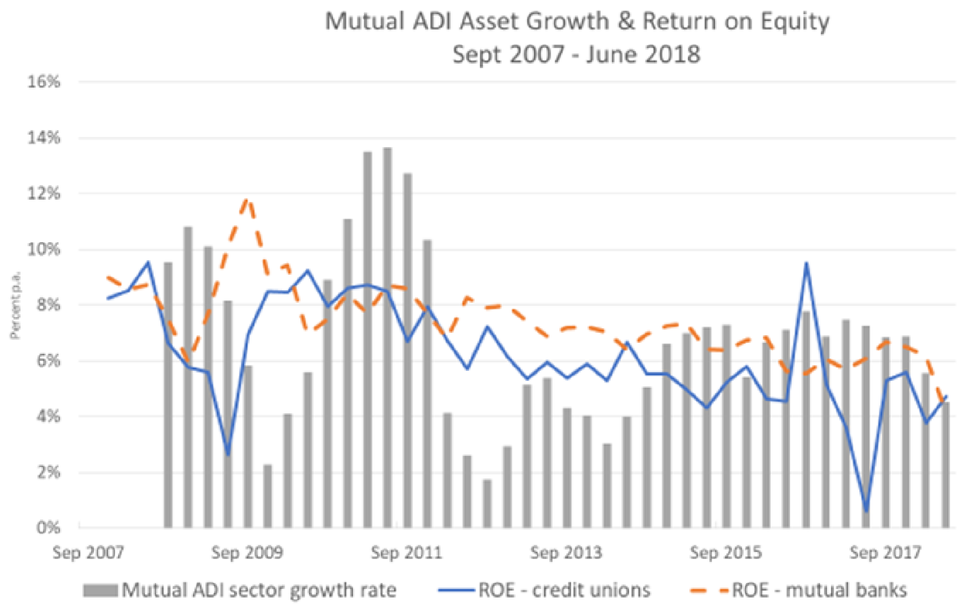
One possibility could be to allow mutuals to have lower required capital, but only if they pay an annual fee for depositor protection. This could be an add-on to the Financial Claims scheme – with no fees if regulatory capital is high, but an increased fee if capital is low. It may well be that the payment of such an annual fee would be less of an impediment to growth than the need to increase regulatory capital.

Another possibility is to allow mutuals to offer a different type of investment/savings product based on the peer to peer lender approach. Investors in such a product (called say a "loan fund unit") would have a direct interest in a diversified portfolio of loans. A higher return than paid on deposits could be expected, but the investors would be at risk of loss if loan defaults were high.

Regulatory capital for credit risk would not be required of the mutual, because the investors are bearing that exposure. Some, much smaller, capital requirement for operational risk would still be required.

Whether such loan fund units would prove attractive and provide funding for greater lending competition via a "fifth pillar" is, of course, open to question.

But without some such radical policy and regulatory changes, the opportunity for a competitive breakthrough will not be fulfilled.



Source : APRA

(Pre 2011, mutual bank figures are for building societies)

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