

# Unexpected Outcomes of the Financial Institutions Act

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## Abstract

*The Financial Institutions Act of 1992 provided a new legislative and regulatory framework for non-bank deposit-taking financial institutions (NBFIs), Building Societies and Credit Unions. The expectation of the Act was that the NBFIs would cater to the household sector of the economy and that the two types of NBFI would retain different balance sheet structures. However, the new regulation regime caused credit unions to change their lending policy to emphasis mortgage, rather than personal loans, and thus comerge to similar structure to building societies.*

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## **INTRODUCTION**

In July 1992, a new national system of prudential supervision of deposit taking Non-Bank Financial Institutions (NBFI), i.e. Building Societies and Credit Unions, was introduced after considerable official discussion following the failure of major building societies and credit unions in the late 1980s and early 1990s. The enabling legislation was the Financial Institutions Act which provided a new basis for the registration and operation of Building Societies and Credit Unions. This legislation was co-operative federalism being based on the enactment of common state legislation which created a new national supervisory authority and new State supervisory authorities for the individual States. The legislation created detailed new prudential standards for all NBFI established under complementary legislation. The expected outcomes of the new legislation were that two distinct types of mutual deposit taking NBFIs, distinctive from banks, would serve different roles in the financial sector, would be readily identified by the structure of their balance sheets and would be able to operate successfully under the stringent new prudential standards which were derived from, and closely related to those applying to banks. NBFI were expected to cater for the requirements of the household and unincorporated enterprise sector in the economy. The two distinctive types of NBFI were Building Societies and Credit Unions. Building Societies were specialist mortgage finance lenders which could adopt either the mutual or propriety form of organisation. Credit Unions were required to be mutual organisations with a common bond of association requirement for membership and were expected to specialise in consumer finance.

This new system remedied the deficiencies of the old State based system, provided new lending opportunities for the deposit taking NBFIs and expanded opportunities for inter-state trading. However, the adjustment of the deposit taking NBFIs to the new legislative order produced outcomes which were not fully foreseen and which constituted a substantial change to the deposit taking NBFIs. The adjustment was dictated by market forces and not by the requirement to observe black letter law.

The responses by the NBFI differed: Building Societies changed corporate structure and many converted to banks; Credit Unions, unlike Building Societies, which are constrained by the legislation to remain as mutual societies prohibited from raising permanent tradable share capital have adapted by increasing substantially the amount of mortgage finance provided so

that their balance sheet structure has converged to that of building societies. The unexpected outcomes are that the Financial Institutions has lead to the substantial decline of the deposit taking NBFi sector and the rapid and almost complete convergence of building societies and credit unions. This economic analysis of particular legal rules, in this case, legislative rules, shows that economic incentives dominate black letter law and allows some suggestions as to changes to the legislative arrangements applying deposit taking NBFIs. Regulation of NBFi was transferred to the Australian Prudential Regulation Authority following implementation of the Wallis Committee reforms.

## **REASONS FOR THE INTRODUCTION OF THE FINANCIAL INSTITUTIONS ACT**

Prior to 1992, building societies and credit unions were chartered under State legislation and were supervised under prescriptive systems by State agencies. During the 1970s, building societies had shown instability being particularly vulnerable to runs as there was a severe maturity mismatch on their balance sheets<sup>1</sup>. In 1987, the Western Australian Teachers Credit Union, the largest in the State, was taken over by the then Rural and Industries Bank. The failure of this credit union was described as the result of “an overstretched capital base and poor credit control”.<sup>2</sup>

Concern about the stability of the NBFi sector came to a head in early 1990 with the run on the Pyramid Building Society, one of three in the Farrow group. Although over \$200 million was withdrawn from the Pyramid Building Society in one week in February 1990, Victoria officials and Ministers made what turned out to be inaccurate and ill-advised statements of support for Pyramid Building Society.<sup>3</sup> The Registrar of Building Societies issued a public statement on 12 February 1990 which stated in part:

*“In relation to Pyramid Building Society, the Registrar noted that Pyramid currently has liquid assets in excess of \$400 million. Building Societies are required to lodge detailed monthly financial reports with the Registrar. These show that the Society has*

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<sup>1</sup> An account of the problems permanent building societies faced in the 1970s is given by T G Beale, Financial Instability and the Queensland Building Societies”, *Economic Analysis and Policy*, 7, 1984.

<sup>2</sup> An accessible case study of this failure is given in Bruce Felmingham and William Coleman, *Money and Finance in the Australian Economy*, Sydney, Irwin, 1995, p423

<sup>3</sup> Details of the collapse are taken from D.J. Habersberger, *Farrow Group Inquiry Final Report*, Melbourne, Government Printer, 1994

*adequate asset backing and is responsibly managed. Ongoing monitoring of the Society has revealed nothing of concern.”*

On 28 March 1990, the press release accompanying the audited accounts for the Farrow Corporation stated that the auditors had ‘confirmed Pyramid had liquid funds in excess of 12 per cent. They also said Pyramid had complied fully with major requirements of the Building Society Act and that its policy of having liquid funds in excess of the Government’s Regulated level had proved prudent in the current environment.’ On 22 June 1990, the three building societies in the Farrow group, Pyramid, Geelong Building Society and Countrywide Building Society closed permanently with the appointment of an Administrator. In August 1990, the deficiency in the estimated realisable assets of the Farrow group was \$252 million. This estimate increased to \$455 million in September 1990 while the total losses of the Farrow group were estimated in June 1993 to be \$1033 million. The collapse of the Farrow group raised concern in a number of areas. The first was the contagion effects as depositors in other building societies in all States withdrew funds. The capital position of the Farrow group was revealed to be much more inadequate than the accounts might suggest. In order to increase the capital base to meet the requirement of 2.5 per cent of assets as required by the Building Societies Act, the Farrow building societies, in 1986, created three classes of shares:

1. Permanent Shares
2. Borrowing Shares
3. Investing Shares

Investing Shares comprised four distinct types of shares:

1. Indefinite term Investing Shares
2. Fixed term fully paid Investing Shares
3. Fixed term contributing Investing Shares
4. Non-withdrawable Investing Shares

The characteristics of Investing Shares were unlike those typically associated with ordinary shares; owners of Investing Shares were not eligible to receive dividends and received only interest and were able to exercise only one vote per share holding not one vote per share. Non-withdrawable Investing Shares were actively marketed to investors as if they were deposits although they ranked behind deposits in the event of the winding up of the society.

Non-withdrawable Investing Shares were the major component of capital for the Farrow Building Societies as is shown in the table below.

**Table 1:** Capital Ratios of Farrow Group of Building Societies; Type of Capital as a Percentage of Total Assets - December 1989

Building Society	Permanent Capital	Reserves	Non-withdrawable Share Capital	Total Capital
Pyramid	0.11	0.31	5.34	5.76
Geelong	0.92	0.40	5.50	6.82
Countrywide	0.63	0.33	4.80	5.76
Federation	0.60	0.39	4.10	5.09

In the event of the failure of the Farrow Building Societies, investors holding Non-withdrawable Investing Shares lost all their funds. Use of Non-withdrawable Investing Shares had allowed the Farrow building societies to meet the new capital requirements while allowing the holders of permanent shares to maintain control of the societies without any marked dilution of control.

## THE NEW SYSTEM OF SUPERVISION

In 1990, a Committee of Inquiry was established in Queensland to examine the role of non-bank financial institutions in Queensland and this Committee recommended supervision by an organisation at arms length from government, based on the Reserve Bank system, with co-operation between States<sup>4</sup>.

The basis of the recommendations of the Brady Committee were State based NBFIs perform a genuine role in the process of financial intermediation; this role focuses on the borrowing and lending needs of the financial sector<sup>5</sup>. The fundamental principle of prudential supervision was that responsibility of each NBFIs lies with the owners and managers while the responsibility of the supervisor is to protect the interests of depositors and to ensure that they do not bear any uncontracted risk. Supervision is not concerned with the success or survival of individual NBFIs or of the industry as these matters are determined by competition in the market<sup>6</sup>. The Farrow building societies case is a good illustration of depositors bearing

<sup>4</sup> Brady Committee Report, *Report of the Independent Committee of Inquiry into Non-Bank Financial Institutions and Related Financial Institutions and Related Financial Processes in the State of Queensland*, Government Printer, Brisbane, 1990

<sup>5</sup> Brady Committee Report, p76

<sup>6</sup> Brady Committee Report, p81

uncontracted risk. Depositors were sold non-withdrawable investing shares which possessed a higher risk than deposits but were lead to believe that two financial claims were, in practice, identical.

Subsequently, a meeting of State Premiers in late 1990 established Heads of Agreement for national supervision of NBFIs and these were put into effect by the common and uniform legislation passed by all States in 1992<sup>7</sup>. The new system of supervision had a two-tier structure: at the apex is the Australian Financial Institutions Commission (AFIC) which determined national prudential standards while each State had a State Supervisory Authority (SSA) which was responsible for the on-ground supervision of NBFIs. The prudential standards were comprised of a capital adequacy requirement which was very similar to the BIS standard adopted by the Reserve Bank for banks; liquidity requirements similar to the PAR and supported by industry provided liquidity schemes. The system differed initially from the Reserve Bank supervision of banks in providing for on site inspections of NBFIs although the Reserve Bank since the Martin Committee Report<sup>8</sup> was implemented on-site inspections of banks. In general, the prudential regulations are more stringent than for banks.

As many institutions initially would have not been able to meet the capital adequacy requirements a two year period to provide for transitional arrangements was allowed. For example, at 30 June 1993, 14 credit unions had not meet the capital requirements.

Unlike the Reserve Bank's supervision of banks, which does not place a charge on banks, the costs of the NBFIs supervision scheme are fully met from an annual levy on NBFIs.<sup>9</sup> This levy has, at times, been a bone of contention amongst NBFIs<sup>10</sup>, and continues as a matter of concern as the asset base of the NBFIs under AFIC supervision diminishes. Deposit-taking non-bank financial institutions are now constituted under the Financial Institutions Act which requires minimum capital standards. The FI Act distinguishes between building societies and credit unions; financial institutions must operate as one or the other and can not operate as both. The Act further provides for "primary objects" which serve to define building societies

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<sup>7</sup> An account of the background to the new legislation is given by Mark Gray, "Non-Bank Financial Institutions Reform", in B. Gilligan, R. Lim and K. Lovegrove (eds), *Managing Micro-Economic Reform*, Federalism Research Centre, Australian National University, Canberra, 1993.

<sup>8</sup> House of Representatives Standing Committee on Finance and Public Administration, *A Pocket Full of Change*, Canberra, 1991.

<sup>9</sup> These charges have not yet been fully met out of current income as in some States the levies are met from balances in statutory contingency funds.

<sup>10</sup> M.H. Waterhouse, *Credit Unions and the Financial Institutions Scheme, Volume 1*, Sydney, Credit Union Services Corporation, 1994, maintains that there is "some doubt whether AFIC's Administration levy is fully

and credit unions. The building societies' primary object is that at least 50 per cent of their loans must be for the purchase of residential development while credit unions rules must contain a clause limiting membership to persons having a common body of association and not less than 60 per cent of its loans are to members. Capital adequacy requirements are that each society must maintain at all times a minimum ratio of capital to risk weighted assets of eight per cent; capital is decomposed into two tiers. Tier 1 is the highest quality capital and consists of general reserves and retained earnings; and for building societies only fully paid permanent share capital, partly paid permanent share capital and non-repayable share premium account. Tier 2 or supplementary capital comprises general provisions for doubtful debts, asset revaluation reserves, minority interests in subsidiaries, perpetual subordinated debt and term subordinated debt; and for building societies only mandatory convertible notes and similar capital instruments, limited life redeemable preference shares and hybrid capital instruments; and for credit unions only restricted -withdrawal membership shares. Tier 1 must constitute 50 per cent of the capital requirements for building societies and 75 per cent for credit unions<sup>11</sup>. Liquidity standards are that each society must maintain at all times a minimum proportion of its balance sheet in specified liquid assets, PLA, where the base is total liabilities excluding capital. Assets eligible for inclusion as PLA include treasury notes, other Commonwealth Government securities, bank deposits and bank accepted and endorsed bills, State of Territory Government issued or guaranteed securities; and deposits with special service providers. Building societies must maintain a minimum PLA ratio of 10 per cent and an operational ratio of 10 per cent<sup>12</sup> while credit unions have to maintain a minimum ratio of 7 per cent and an operational ratio of 8 per cent<sup>13</sup>.

## **NBFI RESPONSE TO THE NEW PRUDENTIAL STANDARDS**

The new prudential regulations created two problems for NBFI. The first was the need to raise more capital to meet the newly imposed capital adequacy requirements. The traditional means of raising capital from retained profits is not a suitable medium to provide for a sudden increase in capital. The second problem is to maintain profit margins when market conditions are moving adversely against NBFI. These pressures are accentuated by the fact

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equitable” and argues that “Competitive neutrality would be best achieved by treating the supervision of credit unions and building societies as a ‘public good’.

<sup>11</sup> Prudential Notes 3.2 and 4.2, Queensland Government Gazette, No. 45, pp766-767.

<sup>12</sup> Prudential Note 3.1 (Building Societies), Queensland Government Gazette, No. 45, pp779-805.

that the new prudential regulations impose increased liquidity requirements as well. In more general terms, the problem of the new capital adequacy requirements for mutual societies can be explained in the following way.

NBFI have a balance sheet of the following form.

#### Stylised NBFI Balance Sheet

Liabilities:	Assets:	
Deposits	D Prime Liquid Assets (PLA)	PLA
Capital	C Loans	L

$$\text{Risk Weighted Assets, RWA} = \sum_{i=1 \dots n} (rw_i \cdot A_i)$$

where

$rw$  = risk weighting factor

Total Income,  $Y_t$ , for a mutual society is Gross Margin, GM, plus interest on required liquid reserves,  $Y_{pla}$ , plus other income,  $Y_o$ .

The gross margins of NBFI, GM, is given by the difference between rates of interest charged on loans,  $R_l$ , and rates of interest paid on deposits,  $R_d$ , so that

$$\text{Gross Margin: } GM = [R_l [(1-LR)D+C] - R_d \cdot D] + R_{pla} \cdot LR \cdot D + Y_o$$

where

LR = Liquidity Requirement (Prime Liquid Assets)

$R_{pla}$  = rate of interest on Prime Liquid Assets

and

D = Deposits

The NBFI net margin, NM, is the gross margin less expenses so that

$$\text{Net Margin or retained profits, RP} = [R_l [(1-LR)D+C] - R_d \cdot D] + R_{pla} \cdot LR \cdot D + Y_o$$

where

$E_x$  = NBFI expenses

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<sup>13</sup> Prudential Note 4.1 (Credit Unions), Queensland Government Gazette, No. 45, pp859-861

Loan interest rates and deposit rates are, for the point of view of NBFI, market determined so that

$$R_l = f_1(B_l, e)$$

and

$$R_d = f_2(B_d, f)$$

where

$B_l$  = Banks' loan rates

$B_d$  = Banks' deposit rates

and

$e, f$  represent other factors; the more important being the risk differential between banks and NBFI. The NBFI expected that the new supervision standards would improve the market perception of the risk attaching to NBFI allowing them to raise funds at a lower rate. It would be expected that NBFI would pay higher deposit rates and charge higher loan rates as compared to banks so that

$$R_d > B_d$$

and

$$R_l > B_l$$

The new capital adequacy requirements constrain the size of NBFI according to the following formula:

$$\text{Risk Weighted Assets, RWA,} = (1/\text{CR}) \cdot \text{RP} = \sum_{i=1 \dots n} (r w_i \cdot A_i)$$

where

CR = capital adequacy requirement

The expansion of NBFI assets is given by the expression:

$$\Delta \text{RWA} = (1/\text{CR}) \cdot \Delta \text{RP}$$

where

$\Delta \text{RWA}$  = increase in risk weighted assets

and

$\Delta \text{RP}$  = Increase in Retained Profits

NBFI are faced with two constraints: a capital and a liquidity constraint. The effect of the new supervisory standards depend on which constraint is effective and on what form the

constraint takes. The capital constraint is the one which is restrictive. What form the constraint takes depends on the type of NBFIs. For building societies, the effective constraint is the Tier 1 requirement which requires building societies to maintain a minimum of four per cent of risk-weighted assets as Tier 1 capital (total capital adequacy requirements can be met by subordinated debt). On the other hand, the credit unions face the more stringent requirement to hold a minimum of six per cent of risk-weighted assets as Tier 1 capital; the requirement may be more stringent as credit unions must provide all capital from retained profits. If this is so, then for building societies, their expansion is limited by

$$\Delta RWA = (25). \{ \Delta [R_1 (0.8)D + C - R_d.D] + R_{pla}.0.2D + Y_o - E_x \}$$

For credit unions, the constraint can be expressed as

$$\Delta RWA = (12.5). \{ \Delta [R_1 (0.85)D + C - R_d.D] + R_{pla}.0.15D + Y_o - E_x \}$$

The most favourable circumstance for credit unions is given by

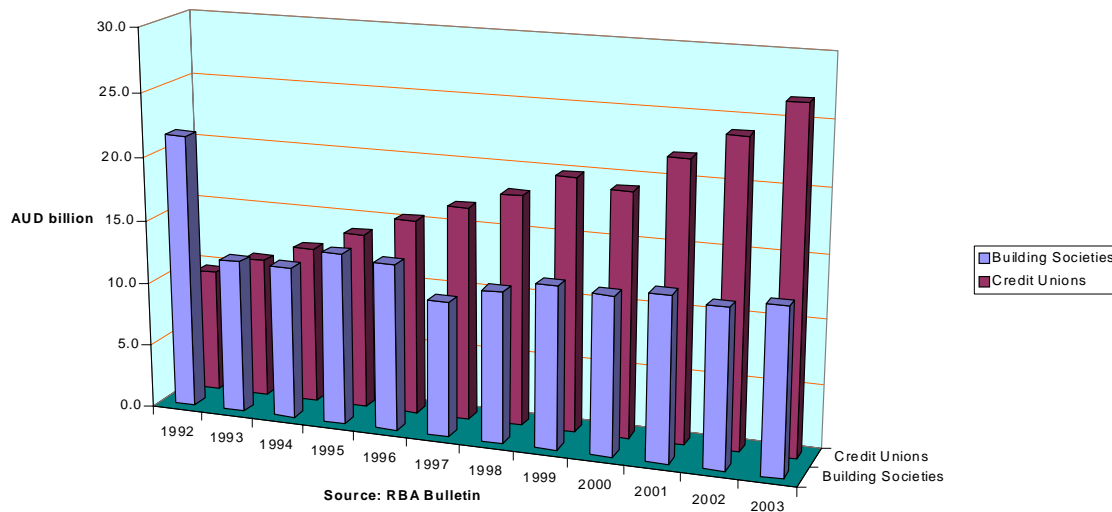
$$\Delta RWA = (16.7). \{ \Delta [R_1 (0.85)D + C - R_d.D] + R_{pla}.0.15D + Y_o - E_x \}$$

The immediate responses to the imposition of the new supervisory requirements are:

1. de-mutualise and issue share capital tradable on the Australian Stock Exchange or on an exempt market;
2. raise Tier 2 capital by issuing subordinated debt;
3. change their lending policy to reduce the risk-weighting of assets;
4. reduce expenses; and
5. merge;
6. convert to another form of financial institution.

An overall view of the change in the NBFIs industry is given by the Chart below:

Building Societies and Credit Unions, Total Assets, Australia, 1992-2003



The decline in building society assets resulted from conversion of building societies to banks. One large building society, St George, converted to bank status in July 1992 and did not come under the new scheme while the Co-operative Building Society from South Australia, converted to the Adelaide Bank from the beginning of 1994. A further loss occurred from July 1995 when the Bendigo Building Society became a bank. In 1996, when the Queensland government announced a merger of its financial conglomerate Suncorp with Metway Bank, Suncorp Building Society was removed from the NBFi industry<sup>14</sup>. St George Bank Ltd gave the following reasons for declaring its conversion from a Building Society was successful:

1. higher earnings on its liquid assets,
2. more diversity in its wholesale funding and
3. greater access to international markets<sup>15</sup>.

In addition, conversion is an attractive option as it results in lower compliance costs and greater opportunities to trade inter-state. Three building societies in Queensland, the Rock, Northern, and Ipswich and West Moreton have converted to company status and listed

<sup>14</sup> Suncorp Building Society Ltd is the largest building society in Australia now comprising over 20 per cent of total industry assets and has an anomalous status as the only government owned building society in Australia. While ownership by any one interest of a building society is restricted by the FI Act to 10 per cent, there are exemptions to this requirement. Exemptions are provided under Prudential Note 3.4 (Building Societies) especially Prudential Standards, Ownership and Control, 3.4.2 Concentration of Ownership, Queensland Government Gazette, No. 45, pp833-834

successfully on the ASX. Two other Queensland building societies, Wide Bay and Mackay, converted to company status and issued permanent shares which trade on an exempt market. Other building societies, one example from Queensland, Heritage Building Society, have increased its Tier 2 capital by issuing subordinated debt.

The problem for credit unions in responding to the capital requirements was that they were constrained in their ability to provide capital from retained earnings. We assume that loan rates and deposit rates,  $R_l$  and  $R_d$ , are exogenously determined to credit unions and that they essentially follow the lead of banks in changing these rates. Other sources of income such as interest earnings from liquid asset holdings,  $Y_{pla}$ , and other income,  $Y_o$ , are unlikely to be significant. Substantial increases in  $Y_{pla}$  are unlikely in a low interest rate environment while credit unions have generally tried to absorb those fees which banks would pass on to depositors or borrowers. Credit unions have held an advantage over competing financial institutions in having a lower expense structure. In part, this lower structure was due to either implicit or explicit subsidies provided by the organisations which gave the common bond of association to credit union members such as employers or trade unions. In further part, this advantage derived from the more restricted range of financial activities offered by credit unions. In still further part, the advantage was a result of volunteer membership of credit union Boards and committees.

In 1996/7, credit unions became subject to taxation at a transitional rate and paid tax at the full rate in the following year, 1997/8. While some of this expense advantage will remain with credit unions, it seems unlikely that credit unions will be able to make a significant reduction in expenses particularly if they continue to provide a full range of financial activities for, and introduce new services to, their members. The effects of cost pressures on credit unions are shown by their performance in relation to operating profit before tax. While total assets of major credit unions increased by 13 per cent in 1995, a similar rate to the previous year, the increase in operating profit before tax increased by only 0.12 per cent as compared with a profit increase of 20 per cent in 1994. During 1995, the cost-to-income ratio increased from 75.2 per cent to 76.4 per cent.<sup>16</sup> Interest rate margins, as shown, below have shrunk.

Interest rate margins, NBF, Australia, 1995 and 2001

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<sup>15</sup> Australian Financial Review, 24 November 1993

	<b>June 1995</b>	<b>March 2001</b>
Credit Unions	6.0	4.8
Building Societies	3.7	2.8

APRA 2001

Credit unions have improved their capital adequacy position without having to raise more capital by increasing their lending for owner occupied housing. The following stylised balance sheet shows how this can be done.

#### Hypothetical Balance Sheet of a Credit Union

Liabilities:		Assets:		RWA:
Deposits	94	Cash and Liquids	15	0
Capital	6	Owner Occupied Housing Loans	10	5
		Other Loans	75	75
Total	100	Total	100	80

Capital adequacy requirement is 6.4 (.08 of 80); giving a short fall of 0.4 or 6.25%.

Increasing the proportion of owner occupied housing loans will change the balance in the following way:

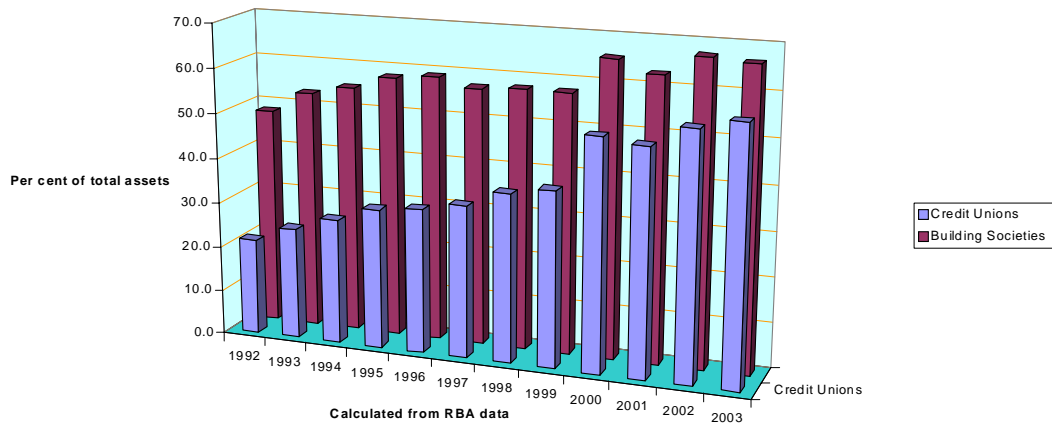
#### Hypothetical Balance Sheet of a Credit Union After Change in Lending Policy

Liabilities:		Assets:		RWA:
Deposits	94	Cash and Liquids	15	0
Capital	6	Owner Occupied Housing Loans	20	5
		Other Loans	65	65
Total	100	Total	100	70

Capital adequacy requirement is 5.6 (.08 of 70) and the credit union now meets the requirement without raising more capital. Since 1988, the proportion of owner occupied housing loans in credit unions' books has steadily. This is shown in the Chart below:

<sup>16</sup> KPMG 1996 Financial Institutions Performance Survey, p35

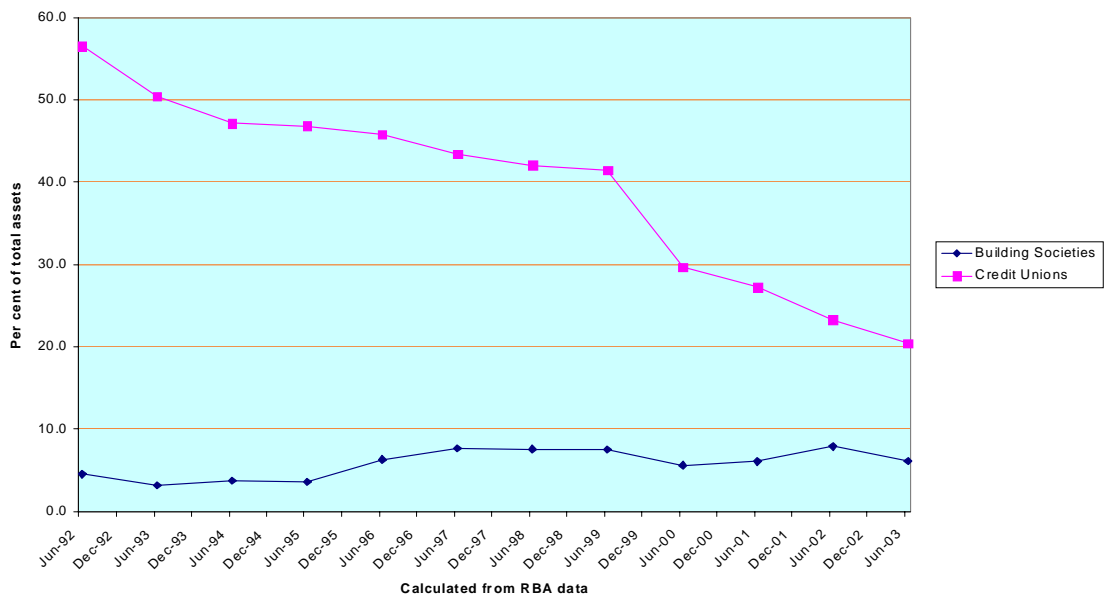
**Building Societies and Credit Unions, Residential Lending, Australia, 1992-2003**



Credit union lending for residential purposes has increased from 20 per cent of total assets in 1992 to over 50 per cent in 2003 and has converged to a similar proportion of building societies assets.

In consequence, personal loans, once the back bone of the credit union industry, has fallen substantially as a proportion of total assets as shown in the Chart below:

**Building Societies and Credit Unions Personal Lending, Australia, 1992-2003**



Personal lending by credit unions accounts for only 20 per cent of total assets on 2003 although it remains higher than in building societies. The relative fall in credit unions personal loans reflects, in part, their attempts to reduce bad debts in the area (and thus

maintain retained profits) and to counter the increased competition from finance companies in the area of loans to consumers for motor vehicles. Finance companies, using sophisticated credit scoring models, can approve loans quickly and with a minimum of documentation. Credit union procedures for personal loan applications and approvals remain cumbersome; typically approval is delayed by need to refer to a credit committee rather than the lending officer. The pressure on credit union margins will continue to intensify as other financial institutions move into the personal loan market. The banks can be expected to attempt further penetration of the home loan market and in doing so create new mortgage based loans which allow loans for furniture, swimming pools, cars and even holidays to be bundled together with a housing loan. Recent changes to credit card pricing and interest rate structure have made credit card finance competitive with personal loans for some purposes, especially for small loans. However, the banks themselves are under pressure from the nonbank mortgage originators. Building societies have already shown that they wish to shorten the maturity of their portfolio by moving into consumer loans and can be expected to continue to make inroads in this market. Other financiers can employ the new financial techniques available to improve their products in opposition to credit union personal loans. An example previously cited is the strong resurgence of finance companies in the motor vehicle financing arena. It would thus seem a reasonable prediction to make that the scope for credit unions to improve capital adequacy by changes in the portfolio towards greater concentration of mortgage loans will be limited. If this proves to be so, credit unions will come up against the very real problem of having to raise new capital or remained constrained in their growth by the expansion of retained profits.

## **EFFECTS OF THE FINANCIAL INSTITUTIONS ACT**

The Financial Institutions Act was based on the premise that there was a real role for building societies and credit unions in meeting the financial needs of the household sector. The Financial Institutions Act removed many of the overly-prescriptive regulations on these institutions and provided a new structure which removed many of the implicit risks facing depositors. However, the Financial Institutions Act is highly prescriptive as to the structure of societies in that it prescribes that societies have a prime objects clause which attempts to impose a particular balance sheet structure on the two classes of societies. In addition, as the Financial Institutions legislation specifically prohibits credit unions from issuing permanent

tradable share capital, the Act provides no avenue for credit unions to obtain capital for expansion. Credit Unions have responded to this difficulty by changing their lending policy to make more loans on mortgage. In doing so, they have converged towards the structure of building societies so that many credit unions would meet the legislative requirements to be building societies.

The outcomes of the operation of the Financial Institutions Act have been:

1. a reduction in the size of the NBFIs sector;
2. a substantial exodus from the building society industry;
3. a convergence of building societies and credit unions in balance sheet structure; and
4. potential difficulty for funding the prudential supervision as the asset base of the industry has not grown.

## **THE FUTURE OF NBFIs**

At this juncture, the effects of the economic forces which have led to the outcomes considered above appear set to continue. The important market pressures affecting the position of NBFIs are:

1. Competition in loan markets;
2. Increase in expenses for NBFIs;
3. Change in the Cheques and Payments Orders Act;
4. Removal of restrictions on holding accounts with NBFIs;
5. Taxation; and
6. Closure of bank branches.

Competition in the markets for loans to the household sector is likely to intensify as banks shift their effort to personal loans in response to the pressure from the non-bank mortgage originators and adopt credit scoring models to approve loans. The prospect for NBFIs is that their margins will continue to be squeezed.

The increase in bank fees has led to a shift of customers away from banks to NBFIs which have absorbed government charges and which have been loath to charge explicit fees. To the

extent that these customers have high transaction, low balance accounts, NBFIs may experience a net increase in expenses. Some NBFIs have indicated their intention to charge transaction fees which limits their attractiveness to depositors. As has been discussed, credit unions are now subject to taxation which impacts on their net margin. Nevertheless there are some positive signs for NBFIs. The Cheques and Payments Orders Act has been amended to allow building societies and credit unions to issue cheques in their own right rather than through the agency with a bank. The NSW government removed restrictions on government departments and authorities on holding accounts with building societies and credit unions. The closure of bank branches in country towns, particularly in New South Wales and Queensland has created an opportunity for NBFIs to expand.

#### Summary of Market Pressures on NBFIs

	Building Societies	Credit Unions
Rates of interest charged on loans, $R_l$	-	-
Rates of interest paid on deposits, $R_d$	0	0
NBFI expenses $E_x$	0	+
NBFI fee income $Y_o$	+	+

Note:

- indicates a possible decrease
- 0 indicates no change
- + indicates a possible increase

## ALTERNATIVES FOR NBFIs

### A Generic NBFI

One possible policy change in the regulation of NBFIs would be to provide for one class of NBFI, a generic NBFI, which had to meet prudential standards similar to those of banks. It would be consistent with the implied intentions of the legislation to leave it to individual NBFIs to determine what they call themselves and to the market to judge if this is credible. This is, of course, the position in regard to banks. While the banking legislation regulates banks it allows a variety of types of banks to operate under a common set of prudential standards. Clearly, credit unions are placed in a particularly restrictive position in having to

meet capital adequacy requirements with 75 per cent in Tier 1 unlike both building societies and banks which have to maintain a minimum of 50 per cent in Tier 1 capital<sup>17</sup>.

### **Mutual Societies and Risks**

It may be argued that the different capital requirements are necessary to take account of the difference in risks borne by depositors in mutual societies. credit unions. However, in both formal and actual terms, the role of a depositor in a mutual society is quite different to a depositor in a propriety company. In a mutual society, a depositor is a member of the society, has voting rights, and is entitled to share in the profits of the society; hence, the role of depositor and equity participant is blurred. A depositor in a propriety company, such as one of the banks or a building society listed on the Stock Exchange, has no right to participate in the profit of the company. If anything, a depositor in a mutual society bears, and should bear, a greater degree of risk than a depositor in a propriety company and, hence, mutual societies should have a lesser prudential standard than a propriety company rather than a greater.

### **New Forms of Capital for Mutual Societies**

If it is thought necessary to require credit unions to be mutual societies, it is possible to devise new forms of capital which can preserve the organisational status of credit unions but allow them to raise permanent capital. If this new capital were tradable capital, issues of capital by credit unions would create a new market test of the performance of credit union management. Under the prudential standards which impose capital adequacy requirements, the role of capital is seen as providing a buffer for losses to protect the interests of depositors at the expense of equity holders.

One requirement for capital to meet capital adequacy requirements is that it be permanently available for this role. One such type of capital which would meet these criteria is the type proposed by the Building Societies Commission for UK building societies. This form of capital is referred to as permanent interest bearing shares, PIBS, and has the following characteristics:

- a. it will be permanent;
- b. it will be interest bearing, not profit related;

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<sup>17</sup> This has been argued by Kevin Davis, "Prudential Regulation and Australian Credit Unions", *Australian*

- c. interest can be waived, if the society's capital position requires it;
- d. it can be written down to absorb losses without triggering a winding up of the society; and
- e. on winding up a society, holders of PIBS rank behind not only ordinary creditors, including depositors, but also holders of withdrawable share capital and subordinated debt.

In this form, PIBS is analogous to non-redeemable preference shares issued by joint stock companies and hence would be permanent. There is no need to insist that this capital is non-marketable; indeed, there is every reason to insist that PIBS is tradable capital. Trading PIBS in an exempt market such as some non-listed Building Societies have for their capital issues would provide a welcome market test, which is now conspicuously absent, for a credit union. The rate of return on PIBS has to be interest related not profit related. Two approaches to pricing PIBS recommend themselves. The first is to set the rate of interest payable on PIBS as a rate equivalent a market benchmark rate plus a margin. Candidates for the benchmark rates would be leading market rates such as the long term bond rate or the 90 day BAB rate. The alternative candidate for the benchmark rate is a credit union deposit rate such as the rate on a term deposit of a given maturity. The choice between rates depends on whether the reference point for the test of credit union management is the general market or the performance of the credit union itself. A benchmark rate of the long term bond rate would require the credit union to produce returns equivalent to those available in financial markets while a credit union benchmark rate would place pressure on credit union management to produce returns comparable with those paid to depositors. If our previous assumption about credit union rates being closely determined by market rates is a correct representation of the actual position then the choice is largely immaterial and may be made on marketing grounds. The choice of the margin would be determined by the risk premium appropriate to PIBS and would be determined reference to actual market considerations at the time of issue. In a mature market for PIBS, one would expect a wide variety of issues with different benchmark rates and margins with their price reflecting the current market rate of return. PIBS would be issued to members of the credit union so that holders of PIBS would hold voting rights and could use those votes to influence membership of the Board and of credit union policy. It would be important to ensure that PIBS were tradable in a secondary market which would allow holders liquidity without affecting the liquidity of the credit union itself. It could be expected that there would be a market for PIBS; there is, in general, a market for financial

instruments paying a high and reliable return among retired investors. While it can be argued that PIBS are not risk free, the counter arguments are that they would be priced to reflect this risk and that they would be actually less risky than other financial assets which have attracted substantial funds from retired investors. Obvious examples are unlisted property and other trusts. Regulators would be expected to insist that there be some limit on the amount of PIBS issued. However this is unnecessary as long as PIBS are marketable (and there is unlikely to be a demand for them if they are unmarketable) because the risk attaching to PIBS in the eyes of investors will increase as the proportion of PIBS in total capital of the credit union increases. This is because in the event, however remote, of winding up the credit union, holders of PIBS have little by way of a buffer from losing their capital in whole or in part. The major argument against this proposal is the one derived from the Farrow case. PIBS could be sold to depositors who are unaware, or ,of more concern, who have been misled about the status of such shares and who are required to bear uncontracted risk.

## **CONCLUSIONS**

The introduction of new legislation for State based deposit taking NBFIs lead to unexpected outcomes. Both credit unions and building societies have adjusted their lending policy to meet the imperatives of the new legislation but in doing so have moved away from the role envisaged by the legislation. Credit unions have been able to adjust to the new prudential requirements by changing their lending policies but, in doing so, are moving away from their traditional base; moreover such adjustments cannot continue for ever. Also as a result of the adjustment, credit unions are beginning to converge in lending policy and balance sheet structure with building societies. These developments are driven by economic factors and not by black-letter law as confirmed by the change in regulation of NBFIs following the Wallis report recommendations.

If NBFIs are worth keeping as an important financial institution in the household sector, changes to their legislation are worth considering. These changes are:

- (1) the creation of a new category of NBFIs, the generic NBFIs, which has no primary objects clause;
- (2) allowing credit unions to issue new forms of capital which jointly meet the objectives of prudential supervision and the needs of the societies; and

(3) relaxing the capital adequacy and liquidity requirements for mutual societies.

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