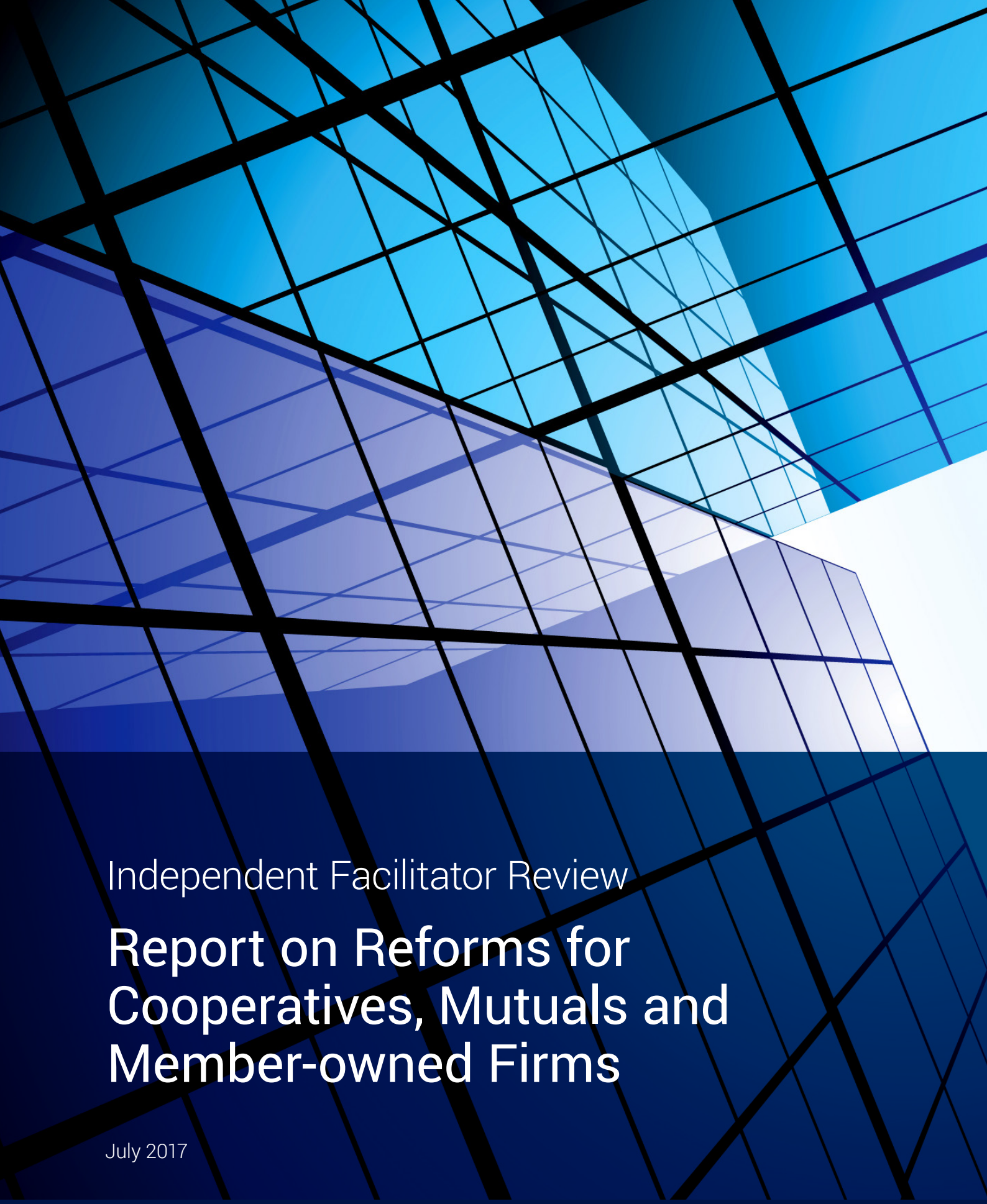

Independent Facilitator Review

Report on Reforms for Cooperatives, Mutuals and Member-owned Firms

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LETTER OF TRANSMITTAL

26 July 2017

The Hon Scott Morrison MP
Treasurer
Parliament House
CANBERRA ACT 2600

Dear Treasurer

REFORMS FOR COOPERATIVES, MUTUALS AND MEMBER-OWNED FIRMS

In accordance with the terms of reference, I am pleased to present my review on reforms for cooperatives, mutuals and member-owned firms.

The review is focused on the key issue of enabling Commonwealth-registered cooperatives and mutuals to access a broader range of capital raising opportunities.

The cooperatives and mutuals sector would benefit from the Government responding proactively to the recommendations in the report of the Senate Economics References Committee *Cooperative, mutual and member-owned firms*, particularly the three recommendations in the report which are directly relevant to the review's terms of reference.

I have made 11 recommendations to provide greater clarity and certainty for the sector.

Implementation of my recommendations will improve access to capital, remove uncertainties currently faced by the sector, reduce barriers and enable cooperatives and mutuals to invest, innovate, grow and compete. Modest changes to legislation and regulation are required. The changes will contribute to a more competitive, fairer and stronger financial system.

I commend the recommendations in the review to you.

Yours sincerely

Greg Hammond OAM
Independent Facilitator

FOREWORD

I am pleased to submit this review to the Treasurer to assist the Government in its response to the Senate Economics References Committee report *Cooperative, mutual and member-owned firms* (Senate Report) that was released on 17 March 2016.

The review included a process of further consultation designed to expand on several findings of the Senate Report and encourage a comprehensive consideration of whether regulatory and legislative changes to improve access to capital should be made to support this sector.

There was broad participation in the review with 52 attendees representing 33 organisations who took part in the roundtable meetings. Submissions were received from 28 individuals and organisations and, following the roundtable meetings, supplementary submissions were received from five of those organisations. The Business Council of Co-operatives and Mutuals (BCCM) and the Customer Owned Banking Association (COBA) were effective in ensuring the views of their members were well represented throughout the review process.

Roundtable meetings were also held with the Australian Prudential Regulatory Authority and the Australian Securities & Investments Commission both prior to, and after, the roundtable meetings with other stakeholders.

Further meetings and discussions were held with BCCM, COBA, sector participants and advisers to discuss issues raised in the submissions and roundtable meetings.

I would like to thank the many individuals and organisations that gave their time and resources, and provided background information to various issues raised in the submissions, to assist the review.

Finally, I wish to acknowledge and thank the Treasury staff who acted as the review secretariat for their diligence and support.

MR GREG HAMMOND OAM - THE INDEPENDENT FACILITATOR

Mr Greg Hammond OAM has extensive legal experience, specialising in all aspects of the governance, supervision and regulation of Australia's finance system. Mr Hammond acts as consultant and advisor to participants in the banking and finance sector and charity and not-for-profit organisations.

Mr Hammond was previously a partner at the law firm King & Wood Mallesons and his current positions include chairman of Anglicare Sydney, director of the Australian College of Theology, G&C Mutual Bank and Opportunity International Australia, and Honorary Fellow with the Applied Finance Centre in the Faculty of Business and Economics at Macquarie University.

TERMS OF REFERENCE

The independent facilitator will review:

- the Senate Economic References Committee report on Cooperative, Mutual and Member-owned Firms (Senate Report) and the submissions which informed the Senate Report; and

- the draft Government Response to the Senate Report

regarding:

- what regulatory and legislative barriers currently exist which impede Commonwealth-registered cooperatives and mutuals from accessing capital and how significant those barriers are; and

- the pros and cons of inserting a definition of "mutual enterprise" into the *Corporations Act 2001*; and

make recommendations to the Treasurer on whether:

- there should be regulatory and/or legislative changes to improve access to capital for such businesses and if so, what form those changes should take; and

- a definition of "mutual enterprise" should be inserted into the *Corporations Act 2001*.

It is noted that some cooperatives are regulated by state and territory legislation. However, the independent facilitator may wish to make observations regarding any barriers such cooperatives face in access to capital should they arise during the course of the review.

METHODOLOGY

The independent facilitator will hold roundtable discussions to provide the opportunity for stakeholders with significant interests in the terms of reference to share their experiences under the current law and regulatory settings and to discuss any potential reforms.

TIMING

The independent facilitator will provide a report detailing their findings to the Treasurer by 14 July 2017 or within four months of appointment, whichever is later.

ABBREVIATIONS AND ACRONYMS

AASB	Australian Accounting Standards Board
ABA	Australian Bankers' Association
ACNC	Australian Charities and Not-for-profits Commission
ADIs	Authorised deposit-taking institutions
AMG	Australian Mutual Group
APRA	Australian Prudential Regulation Authority
APS 110	APRA's *Prudential Standard APS 110 - Capital Adequacy*
APS 111	APRA's *Prudential Standard APS 111 - Capital Adequacy: Measurement of Capital*
ASIC	Australian Securities & Investment Commission
AT1	Additional Tier 1 Capital, as defined in APS 111
ATO	Australian Taxation Office
Banking Act	*Banking Act 1959* (Cth)
Basel II	BCBS, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, revised in June 2006
Basel III	BCBS, *A global regulatory framework for more resilient banks and banking systems*, revised in June 2011
CLR Act	*Company Law Review Act 1998* (Cth)
CNL	Co-operatives National Law
COBA	Customer Owned Banking Association
Corporations Act	*Corporations Act 2001* (Cth)
CUA	Credit Union Australia Limited
FSI	Financial System Inquiry
FSR Act	*Financial Sector Reform (Amendments and Transitional Provisions) Act (No. 1) 1999* (Cth)
IASB	International Accounting Standards Board
ICA	International Co-operative Alliance
MEIs	mutual equity interests
NHC	National Health Co-op
NIB	NIB Holdings Limited
OIS	offer information statement
PHIs	private health insurers
RG147	ASIC's *Regulatory Guide 147 Mutuality – Financial institutions*

Senate Committee	Senate Economics References Committee
Senate Report	Senate Committee report *Cooperative, mutual and member-owned firms* (March 2016)
TFIs	transferring financial institutions under the CA demutualisation provisions
Tier 2 Capital	Tier 2 Capital, as defined in APS 111
UK Ownership Report	Report of the UK Ownership Commission *Plurality, Stewardship & Engagement*, March 2012

EXECUTIVE SUMMARY

Cooperatives and mutuals contribute to almost every area of the Australian economy, including agriculture, banking and finance, housing, insurance and retail. The cooperatives and mutuals sector is a significant contributor to the national economy, as well as providing a broad range of valuable social benefits.

A lack of recognition and understanding of the sector, and the cooperative and mutual form, is perceived to be widespread amongst the general public, investors, regulators, advisers, courts and Commonwealth and State Governments.

This lack of recognition and understanding is a significant barrier to growth and accessing capital. Submissions to the review overwhelmingly identified access to capital as the primary barrier to the ability of cooperatives and mutuals to invest, innovate, grow and compete. The historical way in which cooperatives and mutuals raise capital (typically through retained earnings rather than issuing securities to investors) significantly constrains their flexibility and speed of growth.

The report of the Senate Economics References Committee *Cooperative, mutual and member-owned firms* sets out three recommendations directly relevant to the review's terms of reference. The cooperatives and mutuals sector would benefit from the Government responding proactively to these three recommendations.

The nature of the response is different for different types of cooperatives and mutuals:

- first, mutuals registered as companies under the Corporations Act and prudentially regulated by APRA;
- second, other mutuals registered as companies under the Corporations Act; and
- third, cooperatives regulated under State or Territory law which carry on business in States or Territories other than their home jurisdiction.

Mutually owned ADIs have a pressing need to be able to issue instruments which can be included in the highest quality component of regulatory capital: common equity tier 1 (CET1) instruments. At present, they are unable to do so.

An ability for mutually owned ADIs to issue CET1 instruments will enable them to invest, innovate, grow and compete. It will also contribute to the strengthening of the banking system and improving financial stability, contribute to mutually owned ADIs being able to establish unquestionably strong capital ratios, and facilitate the capacity of mutually owned ADIs to raise capital in the event of problems. Mutual friendly societies and mutual private health insurers have a similar, but not as pressing, need. The first three recommendations of the review address the regulatory capital needs of mutuals prudentially regulated by APRA.

The Corporations Act does not currently define a "mutual enterprise" (or a similar term), but in Part 5 of Schedule 4 regulates the demutualisation of mutuals prudentially regulated by APRA.

All mutually owned ADIs, and most other prudentially regulated mutuals, are companies limited by shares, or by both shares and guarantee, and have the legal capacity to issue CET1 instruments. However, by doing so they risk triggering the demutualisation provisions in the Corporations Act (and a similar provision in the Banking Act), whether or not they are intending to demutualise. This uncertainty is a further significant barrier to accessing capital. The fourth and fifth recommendations of the review seek to reduce the uncertainties which arise from the demutualisation provisions and the exercise of ASIC's discretions under them.

The lack of a definition of "mutual enterprise" (or a similar term) in the Corporations Act contributes to the widespread lack of recognition and understanding of the cooperative and mutual form. The case for defining "mutual enterprise" (or a similar term) is, in some respects, an argument for recognition of the separate legal identity of mutuals. However, the primary purpose for inserting a definition is practical: if the Corporations Act is to be amended to provide for mutuals access a broader range of capital raising and investment opportunities as recommended by the Senate Committee, then it is necessary to define a "mutual enterprise" (or a similar term) for these purposes.

Whilst mutuals registered as companies limited by shares, or by both shares and guarantee, have the legal capacity to issue capital instruments, mutuals limited by guarantee do not. In addition, all mutuals (including those prudentially regulated by APRA) are concerned that issuing capital instruments is inconsistent with their mutual structure and risks their mutual status. External observers and regulators may assert that this concern is overstated, but it is strongly felt by the mutuals sector and several participants in the roundtable meetings commented that their organisation had declined to undertake a range of corporate transactions because of the perceived risk of demutualisation.

This is a real and significant barrier to investment, innovation, growth and competition. The eighth and ninth recommendations of the review seek amendments to the Corporations Act intended to reduce this barrier, and provide for mutuals to have access to a broader range of capital raising and investment opportunities.

Other recommendations in the Senate report were also considered by the review. To the extent those recommendations enhance the understanding of the Australian community of the structure and role of cooperatives and mutuals, their implementation is likely to indirectly assist cooperatives and mutuals raise capital. The tenth recommendation of the review responds to one of these recommendations, clarifying the duties of directors of mutuals.

The remaining three recommendations of the review relate some specific barriers identified in the Submissions to the review which, to a greater or lesser extent, impede Commonwealth-registered cooperatives and mutuals from accessing capital.

The review comments on a range of other matters which should be considered by Government if it adopts some or all of the recommendations in the review, and by the key regulators of the cooperatives and mutuals, APRA and ASIC.

REVIEW RECOMMENDATIONS

REVIEW RECOMMENDATION 1

3.36 Government support (i) the ability of mutually owned ADIs to directly issue CET1 instruments, and (ii) APRA giving priority to the consideration of amendments to its prudential standards to permit them to do so.

REVIEW RECOMMENDATION 2

3.41 Government support (i) the ability of mutual friendly societies and mutual private health insurers to directly issue CET1 instruments, and (ii) APRA considering the amendment of its prudential standards to permit them to do so.

REVIEW RECOMMENDATION 3

3.47 Government encourage APRA to facilitate the issue of capital instruments by prudentially regulated mutuals by (i) assisting industry to develop standard template forms for member equity interests (MEIs), other capital instruments and documentation, and (ii) developing minimum service standards (including an agreed process, framework and timetable) for the timely assessment of capital instruments proposed to be issued, and accountability mechanisms for the service standards.

REVIEW RECOMMENDATION 4

3.61 Government encourage ASIC to facilitate the issue of capital instruments by unlisted transferring financial institutions by developing minimum service standards (including an agreed process, framework and timetable) for the timely consideration of applications for exemption from the demutualisation provisions in the Corporations Act (and under the demutualisation guidelines under the Banking Act), and accountability mechanisms for the service standards.

REVIEW RECOMMENDATION 5

3.74 Government consider the continued effectiveness of Part 5 of Schedule 4 of the Corporations Act and the demutualisation guidelines implemented under the Banking Act, and the exercise of ASIC's discretions under them, to determine whether any amendments to legislation or regulations are necessary or desirable.

REVIEW RECOMMENDATION 6

3.82 Government encourage ASIC to have further dialogue with the affected mutually owned ADIs and industry to determine whether the use of an offer information statement with enhanced disclosure would be appropriate for small scale offers of converting capital instruments.

REVIEW RECOMMENDATION 7

3.87 Tax regulations be promptly amended to treat Tier 2 Capital instruments convertible into MEIs in the same manner as Tier 2 Capital instruments convertible into ordinary shares.

REVIEW RECOMMENDATION 8

4.20 The Corporations Act be amended to expressly permit mutuals registered under the Act to issue capital instruments without risking their mutual structure or status.

REVIEW RECOMMENDATION 9

4.25 In committing to amend the Corporations Act to expressly permit mutuals registered under the Act to issue capital instruments, Government also commit to including a definition of a mutual company.

REVIEW RECOMMENDATION 10

5.11 Government encourage ASIC to provide regulatory guidance on the duties of directors of mutuals.

REVIEW RECOMMENDATION 11

5.30 Government encourage ASIC to review the policy basis for the dual regulation of certain offers of securities by State and Territory cooperatives with a view to implementing legislative changes to eliminate this barrier to the raising of capital by those cooperatives.

CHAPTER 1: CONTEXT OF THE REVIEW AND REVIEW PRINCIPLES

BACKGROUND

1.1 On 2 March 2015, the Senate Economics References Committee (Senate Committee) was asked to review and report on the role, importance, and overall performance of cooperative, mutual and member-owned firms and the operations of these firms in the Australian economy.

1.2 The scope of the Senate Committee's review included the operations of cooperatives and mutuals in the Australian economy, with particular reference to economic contribution; current barriers to innovation, growth, and free competition; the impact of current regulations; and comparisons between mutual ownership and the private sale of publicly held assets and services.

1.3 The Senate Committee received 60 submissions and held three public hearings. The Senate Committee released a report on *Cooperative, mutual and member-owned firms* (Senate Report) on 17 March 2016 and made 17 recommendations across a broad range of policy areas with the intent of either raising public awareness of the sector or facilitating their ability to raise capital.

1.4 On 24 March 2017, the Treasurer announced the appointment of Mr Greg Hammond OAM as an independent facilitator to conduct further consultations on several findings of the Senate Report. In particular, Recommendations 4, 16 and 17 of the Senate Report:

- Recommendation 4 recommends that a "mutual enterprise" be explicitly defined in the *Corporations Act 2001* (Cth) (Corporations Act), and its associated regulations.
- Recommendation 16 recommends that the Australian Prudential Regulation Authority (APRA) set a target date for the outcome of discussions with the cooperative and mutuals sector on issues of capital raising and bring those discussions to a timely conclusion.
- Recommendation 17 recommends that the Government examine proposals to amend the Corporations Act to provide cooperatives and mutuals with a mechanism to enable them access to a broader range of capital raising and investment opportunities.

The purpose of this appointment was to facilitate further detailed analysis on the merits of defining a "mutual enterprise" in the Corporations Act, and whether regulatory and legislative changes were required to improve access to capital for Commonwealth-registered cooperatives and mutuals.[1]

1 Recommendations 4, 16 and 17 of the Senate Report are directly relevant to the matters set out in the terms of reference for this review. In addition, Recommendations 5, 14 and 15 of the Senate Report were specifically raised in submissions and the roundtable meetings:
- Recommendation 5 recommends that the role of directors in "mutual enterprises" is defined in the Corporations Regulations to align with the proposed definition of a "mutual enterprise" in the Corporations Act.

The findings and recommendations of this review (Review) are intended to assist the Government to develop a response to the Senate Report.

SCOPE OF THE REVIEW

1.5 Under the terms of reference, the Review was asked to assess the existence and significance of the regulatory and legislative barriers impeding Commonwealth-registered cooperatives and mutuals' access to capital.

1.6 There is no generally accepted definition of what constitutes a cooperative or mutual, and the terms are frequently used interchangeably. The Senate Report did not adopt a single definition for either term, and outlined a broad range of descriptions and definitions used for varying purposes. However, three features of cooperatives and mutuals are worth noting:[2]

- the business and activities of cooperatives and mutuals is guided by an ethos of providing benefits in the provision of goods or services to members (as owners), rather than maximising profits to enable the payment of dividends or distributions to members (as shareholders) or external investors;
- they are democratic organisations in which members typically have equal voting rights (one member, one vote); and
- mutual membership interests are not transferable, except in limited circumstances.

1.7 Further detail on definitional issues is set out in Chapter 2.

1.8 The Review focused on differences in legal structure and considered that the following types of cooperatives and mutuals are 'Commonwealth-registered':

- Mutuals registered (that is, incorporated or deemed to be incorporated) as companies under the Corporations Act and prudentially regulated by APRA.
  - The focus on the review has been on mutual authorised deposit-taking institutions (mutual ADIs or mutually owned ADIs),[3] mutual friendly societies and mutual private health insurers (PHIs).
  - The Review has not specifically considered the need for trustees of member owned superannuation funds to raise capital nor barriers impeding access to capital by such trustees.

- Recommendation 14 recommends that the Commonwealth Government closely monitor the progress of the International Accounting Standards Board in developing solutions to bring cooperative shares under the definition of capital under AASB 132, and, where possible, facilitate equivalent amendments as expeditiously as possible.
- Recommendation 15 recommends that Commonwealth and State Governments support the formalisation of some innovative market-based approaches to raising capital for small and medium sized cooperative and mutual enterprises, in the form of advice and information, as they become available.

Some brief comments on the other Recommendations of the Senate Report are included in Chapter 4.

2 These features are not intended to be complete or comprehensive, but rather illustrative of the different context in which cooperatives and mutuals commonly carry on business and activities.

3 Mutually owned ADI is the term used in APRA's Prudential Standards.

  - The Review has not specifically considered the need for insurers (other than mutual friendly societies) to raise capital nor barriers impeding access to capital by such insurers.

  - No submissions were received from trustees of member owned superannuation funds or insurers (other than mutual friendly societies).

- Other mutuals registered as companies under the Corporations Act.

- Cooperatives regulated under State or Territory law which carry on business in States or Territories other than their home jurisdiction.

  - These cooperatives are 'Commonwealth registered' to the extent that they must be registered as corporations under Part 5B.2 of the Corporations Act and must comply with Corporations Act requirements applicable to corporations (but not those which only apply to companies).

1.9 Cooperatives carrying on business solely within their own State and Territory were not the focus of the Review as they are largely governed by their own legislation, primarily the *Co-operatives National Law* (CNL).[4] However, the terms of reference enable the Review to make observations about barriers they face in access to capital.

1.10 Many cooperatives, incorporated associations and other entities carrying on business solely within their own State and Territory may be registered with Commonwealth agencies for reasons unrelated to the terms of reference. For example, registration with:

- the Australian Taxation Office (ATO); or

- the Australian Charities and Not-for-profits Commission (ACNC).

Such entities could be regarded as 'Commonwealth-registered'. However, the Review has not specifically considered their need to raise capital nor barriers impeding access to capital by such entities (nor were any submissions received from them about any barriers).

REVIEW PROCESS

1.11 The Review invited interested stakeholders to provide written submissions by 19 May 2017. In response, written submissions were received from 28 individuals and organisations. The 25 non-confidential submissions are publicly available on the Treasury website.

1.12 Five roundtable meetings were held, three in Sydney on 25 and 31 May 2017 and two in Melbourne on 2 June 2017. Supplementary submissions were received from five organisations following the roundtable meetings.

1.13 Roundtable meetings were also held with APRA and the Australian Securities & Investments Commission (ASIC) both prior to, and after, the roundtable meetings with other stakeholders.

4 See paragraphs 1.56 to 1.59 for further information on the CNL.

1.14 Further meetings and discussions were held with the Business Council of Co-operatives and Mutuals (BCCM) and the Customer Owned Banking Association (COBA), sector participants and advisers to discuss issues raised in the submissions and roundtable meetings.

1.15 Most issues raised before the Senate Committee were by relatively large cooperatives, or national mutual organisations, and the concerns generally reflected the interests of organisations of that scale.[5] The same comment holds true for the Review.

BACKGROUND ON COOPERATIVES AND MUTUALS

SIZE AND CONTRIBUTION TO THE ECONOMY

1.16 Cooperatives and mutuals contribute to almost every area of the Australian economy, including agriculture, banking and finance, housing, insurance and retail. The diversity of the sector is seen in the variety of structures operating under the umbrella term of cooperatives and mutuals. Enterprises can be owned, controlled and used by, or on behalf of, their customers, employees, a group of like-minded producers or any combination of these.

1.17 The contribution of the cooperative and mutual sector to the Australian economy is difficult to gauge precisely. While the Senate Report classified the scale of the sector as significant, it also stated that difficulties with definition and a lack of available data prevent the development of a detailed picture of the activities and contributions of the sector.

1.18 An indication of the size of the sector is provided by *The National Mutual Economy Report*, an annual publication produced by BCCM and the University of Western Australia, which provides a snapshot of Australia's top 100 cooperatives and mutuals.[6]

1.19 In 2016, the report estimated that there were 2,000 cooperatives and mutuals operating in Australia with an aggregate active membership of 29 million people. The top 100 enterprises had a combined turnover of $30.5 billion (FY2014/15) and combined assets of $143.7 billion (up by 8% from the prior year). In their submission to the Review, BCCM also stated that eight in every ten Australians is a member of a cooperative or mutual.

1.20 The mutually owned ADI sector controls about 10% of the home loan market and has continued to grow balance sheets, earn strong profits and maintain healthy capital positions.

1.21 APRA collects data on all ADIs. As of March 2017,[7] APRA's quarterly statistics show mutually owned ADIs were 79% of all Australian-owned ADIs (78 out of 99 entities). They held a total of $106 billion in assets, 3% of the total assets of Australian-owned ADI's.

1.22 Over the last 10 years, the percentage of assets held by mutually owned ADIs has remained steady, ranging between 2% and 3%. In contrast, the percentage of ADIs identified as mutually owned has declined from 85% in March 2007 to 79% in March 2017.

5 Paragraph 3.1 of the Senate Report.

6 The most recent (2016) edition of *The National Mutual Economy Report* is available on the BCCM website.

7 APRA's March 2017 Quarterly ADI Performance Statistics publication are available on the APRA website.

SOCIETAL CONTRIBUTION

1.23 As well as making an economic contribution, it is widely accepted that cooperatives and mutuals provide valuable, though less quantifiable, social benefits.

1.24 This view is summarised by BCCM in their submission to the Senate Report, in which they state that cooperatives and mutuals:

> *"share important characteristics that distinguish them from companies. They are a self-help response to the mutually identified needs of individuals or organisations. They are driven to meet both financial and social goals."*[8]

1.25 The social function of cooperatives and mutuals has been generally expressed in submissions to the Review. Bank Australia, for example, describes itself as a "customer owned responsible bank, driven by the purpose of creating mutual prosperity for our customers, the community and the environment".[9] Holiday Coast Credit Union "exists to enhance the financial and social wellbeing of its members and their community".[10]

1.26 This societal contribution also finds expression in statements of purpose for individual cooperatives and mutuals. Australian Unity states its "core purpose is to support its members - and the broader Australian community - to access services that enable them to thrive".[11]

1.27 The International Co-operative Alliance (ICA) sets out a list of seven principles that guide how cooperatives should operate, and that distinguish them from other forms of enterprise.[12] The seventh principle is that "co-operatives work for the sustainable development of their communities through policies approved by their members".

BARRIERS TO GROWTH AND INVESTMENT

1.28 Submissions to the Review have overwhelmingly identified access to capital as the primary barrier to growth and investment. In an increasingly competitive environment, cooperatives and mutuals require significant amounts of capital to invest in necessary technology and infrastructure to be able to support their operations, meet the needs of their members and facilitate future growth. However, the way in which they raise capital (typically through retained earnings rather than issuing securities to investors) significantly constrains their flexibility and speed of growth.[13]

1.29 Mutually owned ADIs have expressed their urgent need to invest in critical IT infrastructure given technology has been fundamentally reshaping the way customers access banking services over the past decade. For some mutually owned ADIs, a sizeable investment in technology is required to ensure their ongoing viability to be able to compete effectively with other deposit-takers and providers of credit and lending services.

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8 BCCM submission to the Senate Committee, page 8. See also paragraphs 2.3 and 2.4 of the Senate Report.

9 Bank Australia submission to the Review, page 2.

10 Holiday Coast Credit Union submission to the Review, page 3.

11 Australian Unity submission to the Review, page 1.

12 ICA *Co-operative identity, values and principles*, available on the ICA website. See also paragraph 2.15 of the Senate Report. These principles are also set out in section 10 of the CNL. Section 11 of the CNL provides that in "the interpretation of a provision of [the CNL], a construction that would promote the co-operative principles is to be preferred to a construction that would not promote the co-operative principles".

13 BCCM submission to the Review, pages 2-4.

1.30 Recognition and an understanding of the sector have been identified as a secondary, though significant, barrier to growth. It is submitted that this lack of recognition and understanding of the cooperative and mutual form is widespread and includes the general public, investors, regulators, advisers, courts and Commonwealth and State Governments.

1.31 For example:

- Credit Union Australia Limited (CUA) state in their submission that in interactions with stakeholders there is an "inconsistent understanding of the mutual model and the value it brings to mutual members, the community and the wider Australian economy."[14]

- Yenda Producers Co-operative state in their submission: "Until the Government can recognise Co-operatives as a 'real' business model alternative and understand their structure, workings and value they offer to the broader community, we will never be on a level playing field with the rest of Australia's businesses."[15]

1.32 In a supplementary submission following the roundtable meetings BCCM stated:

> *"The absence of a legal definition of a mutual means that on a day to day basis, regulators are required to make judgements that are not needed with other types of company. This presents a considerable barrier for mutuals in their attempt to compete in a diverse market place. Before anything else, they have to explain and sometimes justify their corporate form and practices. This leads to considerable additional costs for firms in dealing with regulators, where opinion and judgement replaces legal certainty."*[16]

1.33 Further detail on the limitations on access to capital and other barriers to growth and investment is set out in subsequent Chapters.

DEMUTUALISATION

1.34 When faced with these barriers to development and growth, one option for cooperatives and mutuals seeking to expand is to demutualise. Demutualisation is the process of conversion into a company owned by shareholders. Existing mutual membership interests are converted into tradeable (and usually publicly listed) shares.

1.35 In the past 30 years, it is estimated that 40 mutual firms have undertaken the process of demutualisation.[17] The reasons for demutualisation can vary. Evidence provided to the Review indicates a lack of capital as the primary justification. For example:

- In 1995 National Mutual Life stated in its demutualisation document that it required additional capital as expected profits would not create their desired capital reserves.[18]

14 CUA submission to the Review, page 5.
15 Yenda Producers Co-operative submission to the Review, page 1.
16 BCCM supplementary submission to the Review, page 2.
17 **http://www.delisted.com.au/capital-gains-tax/demutualised**.
18 **http://www.moneymanagement.com.au/news/financial-planning/has-demutualisation-experiment-paid-dividends**.

- In 1996, the three reasons for demutualisation listed by Colonial Mutual Life Assurance Society were to give members a value of their involvement in the mutual, to create an ownership structure which maximises value for members and to allow Colonial to raise new capital.[19]

- More recently, in 2007, the demutualisation prospectus issued by NIB Holdings Limited (NIB) stated that "whilst NIB may not require additional capital to achieve its organic growth targets, the Demutualisation and intended Listing will provide NIB with access to capital markets that may facilitate further growth through mergers or acquisitions".[20]

- Similarly, in 2012 the Greenfields Credit Union chairman Allan Pendal stated that their intended demutualisation would provide greater access to capital and improved opportunities for growth.[21]

1.36 BCCM submit that demutualisations across the cooperative and mutual sector have destroyed competition in specific markets and member value in the demutualised businesses. Cooperatives and mutuals address market failure by enabling smaller market participants, enterprises or individuals, to compete in markets that favour larger entrants. Continued demutualisation would mean that consumers no longer have non-listed, member-owned options in the market-place.[22]

1.37 Separate to the risk of weakening competition, the Review has been presented with several reasons why demutualisation is an unattractive option for cooperatives and mutuals looking to increase their access to capital.

- *Contributions by former members*: The process of demutualisation involves the conversion of existing mutual membership interests into tradeable shares. The value of those shares is determined by a consideration of the value built up over time. As a result, demutualisation often provides current members with a financial gain that is disproportionate to their commitment to the organisation. Meanwhile, former members who may have significantly contributed to the success and growth of the organisation do not share in the proceeds of the demutualisation.

- *Maintenance of character and purpose*: As stated above, the contribution and purpose of cooperatives and mutuals is generally viewed as extending beyond purely commercial considerations. Most contributors to the Review saw the central purpose of their organisation as delivering goods or services to their members, and often, delivering positive outcomes to the broader community.

1.38 Demutualisation introduces a real or perceived conflict between the fulfilment of the organisation's historical purpose and the maximisation of profits for newly created shareholders.

19 **http://www.moneymanagement.com.au/news/financial-planning/has-demutualisation-experiment-paid-dividends**.
20 NIB Listing Prospectus, 5 October 2007.
21 **https://thewest.com.au/news/goldfields/gcu-gets-green-light-to-demutualise-list-on-asx-ng-ya-334250**.
22 BCCM submission to the Review, page 4.

1.39 Additionally, it can be argued that past members made their contributions with an assumption that any surplus would be put towards the success of the organisation and the fulfilment of the acknowledged purpose. Stakeholders have submitted that discarding or diluting the historical purpose of the organisation equates to a betrayal of the trust that past members have placed in the organisation and a disregard of the value of their contributions.

CURRENT LEGAL AND REGULATORY TREATMENT OF COOPERATIVES AND MUTUALS

APRA'S PRUDENTIAL REGULATION

1.40 APRA is the prudential regulator of the Australian financial services industry and responsible for enforcing a framework that promotes prudent behaviour by banks, building societies, credit unions and other ADIs, general insurers and reinsurance companies, life insurers and friendly societies, PHIs and most members of the superannuation industry. Mutually owned ADIs, mutual friendly societies and mutual PHIs form part of APRA's regulated population.

1.41 As part of its role, APRA sets rules through its prudential standards about the minimum amount of capital that regulated institutions must hold and the quality of the capital.

1.42 Currently APRA's prudential standards do not allow mutually owned ADIs to be able to issue capital instruments that qualify as the highest quality form of regulatory capital. This has had an adverse impact on mutually owned ADIs and has restricted their ability to meet capital regulatory requirements as compared to other ADIs. This regulatory barrier has only existed since the implementation of the Basel III capital reforms in Australia in 2013.

1.43 The discussion of mutuals' regulatory capital requirements and access to capital is continued in Chapter 3.

INCORPORATION UNDER THE *CORPORATIONS ACT 2001*

1.44 Mutuals are registered under the Corporations Act as one of the following types of companies:

- companies limited by shares;
- companies limited by guarantee; or
- companies limited by both shares and guarantee (which is not a common type of company).

The essential features of these types of companies are outlined in table 1.

TABLE 1: ESSENTIAL FEATURES OF DIFFERENT COMPANY TYPES

COMPANIES LIMITED BY SHARES

- Companies limited by shares are the most common type of company in Australia and are formed on the principle that members' liability is limited to amounts, if any, that are unpaid on the shares held by them.

COMPANIES LIMITED BY GUARANTEE

- A company limited by guarantee is a company whose members have their liability limited to the amounts that they have undertaken to contribute to the property of the company in the event of it being wound up.
- A company limited by guarantee does not have share capital and members are not required to contribute capital while the company is operating. This kind of company does not raise initial or working capital from its members and must rely on debt or retained earnings.

COMPANIES LIMITED BY BOTH SHARES AND GUARANTEE

- A company limited by both shares and guarantee is a company whose members' liability is limited to the sum of the amounts, if any, that are unpaid on any shares held by them and/or the amounts that they have undertaken to contribute to the property of the company in the event of it being wound up.

1.45 The then Corporations Law was amended in 1998 to preclude new companies being registered as companies limited by both shares and guarantee. The relevant amending legislation was the *Company Law Review Act 1998* (Cth) (CLR Act) which also introduced the ability for companies limited by guarantee to convert into companies limited by shares. The amendments were carried over into the Corporations Act.[23]

1.46 Mutuals are not explicitly defined in the Corporations Act and the Corporations Act does not distinguish between mutuals and non-mutuals, except for the demutualisation provisions in Part 5 of Schedule 4 of the Corporations Act (CA demutualisation provisions).[24]

WHAT IS A MUTUAL?

1.47 At common law, the courts have held there are two characteristics which are usually found in a mutual. Effectively, every member must have a voice in the administration of the mutual, and any surplus must ultimately come back to the members.[25]

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23 The reasons given in the Explanatory Memorandum for removing the ability to register as a company limited by both shares and guarantee can be summarised as follows:
- the ability to do so is no longer needed in light of the new ability for companies limited by guarantee to convert to companies limited by shares;
- there are relatively few companies limited by both shares and by guarantee. In 2017, possibly as few as 15 such companies (eight mutually owned ADIs, six friendly societies and one medical defence organisation);
- some aspects of the law did not operate satisfactorily in relation to these companies (for example, the class rights provisions); and
- the international context: the United Kingdom ceased to facilitate the incorporation of companies limited both by shares and by guarantee in 1981 and comparable overseas jurisdictions did not have this type of company at the time of amending legislation.

24 The provisions of Schedule 4 to the Corporations Act and related regulations apply to mutuals which are "unlisted transferring financial institutions", but not other mutuals. The *Financial Sector Reform (Amendments and Transitional Provisions) Act (No. 1) 1999* (Cth) (FSR Act) introduced a new Schedule 4 into the then Corporations Law (carried over into the Corporations Act) following the transfer of regulatory responsibility for building societies, credit unions and friendly societies to the Commonwealth.

1.48 The constitutions of mutuals typically contain provisions which are not found in the constitutions of non-mutuals. For example, the constitution of a mutual will often provide for one or more of the following:[26]

- it is formed for the purpose of providing goods or services to members;
- membership is linked to the provision of those goods or services;
- the payment of dividends to members is prohibited or restricted;
- members typically have equal voting rights (one member, one vote) irrespective of their economic interests in, or dealings with, the mutual; and
- mutual membership interests are not transferable, except in limited circumstances.

1.49 The *Australian Securities and Investments Commission Act 2001* prohibits a corporation from engaging in conduct in relation to financial services that is misleading or deceptive or is likely to mislead or deceive. Similar prohibitions are contained in both Commonwealth and State legislation prohibiting such conduct in other contexts. There is a risk that a business holding itself out to have a mutual structure may infringe these prohibitions if its idea of mutuality does not align with the broader understanding of mutuality within the community or industry.[27]

1.50 Although there is no statutory definition of a mutual, the process of demutualisation for unlisted transferring financial institutions (TFIs), but not other mutuals, is provided for in the CA demutualisation provisions. The CA demutualisation provisions are intended to protect members of certain mutuals by ensuring they receive full disclosure of proposals that might lead to demutualisation. ASIC has a discretionary power to exempt a financial institution from all or part of the disclosure requirements if it is satisfied that the proposal will not result in, or allow, a modification of the mutual structure of the financial institution.

1.51 In *Regulatory Guide 147 Mutuality – Financial institutions* (RG147) ASIC provides guidance on the exercise of its discretionary power under the CA demutualisation provisions:

> *"A company does not have a mutual structure if it converts to a company whose purpose is to yield a return to shareholders. … We take purpose in that context to mean dominant purpose, and we do not consider it fatal to a company's status as a mutual if it provides a return to shareholders. But that purpose must be limited, and must not be the dominant purpose of the company."*[28]

25 *Faulconbridge v National Employers Mutual General Assurance Association Ltd* [1952] 1 Lloyd's List Law Reports 17 at 27, 35 referred to with approval in *Re: NRMA* 33 ACSR 595 at 631).

26 These features are not intended to be complete or comprehensive, but rather illustrative of the different provisions commonly found in the constitutions of mutuals.

27 See paragraph 18 of ASIC's Regulatory Guide 147 Mutuality – Financial institutions,

28 Paragraph 48 of RG147.

1.52 The dominant purpose of a company is assessed by analysing the relationship between the company and its members by reference to two tests:

- *an economic relationship test*: whether the right to share in undistributed surpluses upon the company being wound up is limited to current members, like institutions or charities and whether there are limitations on dividends payable to investor shareholders (if there are any); and

- *a governance relationship test*: ASIC applies several criteria to establish whether the members have real control, on an equal footing with other members, over the way their company is governed.

1.53 The discussion of the CA demutualisation provisions is continued in paragraphs 3.50 to 3.76.

PRINCIPLE OF MUTUALITY UNDER TAX

1.54 The concept of mutuality also plays a significant role under tax law. The ATO has issued a guide on *Mutuality and taxable income.*[29]

1.55 The mutuality principle in tax law is a legal principle established by case law which applies to not-for-profit organisations that are not exempt from tax. It is based on the proposition that an organisation cannot derive income from itself. The principle provides that where a number of persons contribute to a common fund created and controlled by them for a common purpose, any surplus arising from the use of that fund for the common purpose is not income and is therefore not taxable. The mutuality principle does not extend to income that is derived from outside sources or income derived from dealings with members which go beyond mutual arrangements and are in the nature of trade.

COOPERATIVES NATIONAL LAW

1.56 The CNL is a uniform set of laws for cooperatives which is being progressively introduced by the States and Territories to regulate cooperatives. This will be achieved by each State and Territory either adopting the template CNL or (in the case of Western Australia) passing alternative legislation consistent with the CNL. The CNL has been introduced in each State and Territory other than Queensland. New South Wales is the lead (host) jurisdiction for this project, and updates are produced by NSW Fair Trading to keep stakeholders informed about the progress of the introduction of the CNL.[30]

1.57 The word "co-operative" is a restricted word under the *Business Names Registration Act 2011* (Cth) (see item 113 of Schedule 2 of the *Business Names Registration (Availability of Names) Determination* 2015). The effect of the restriction is that only cooperatives registered under State and Territory law may use 'co-operative' in a business name. Other entities can only use 'co-operative' in their business names if the relevant Minister has given written consent for its use.

29 Available on the ATO website.

30 Updates are available on the NSW Fair Trading website.

1.58 The CNL aims to (among other things):[31]

- reduce red tape and associated business costs for cooperatives;
- continue the distinguishing cooperative principles developed by the ICA;
- implement modern principles of corporate governance similar to requirements for other corporate entities, assisting cooperatives to compete on a more 'level playing field' with these entities; and
- facilitate the issue of Co-operative Capital Units (CCUs) by cooperatives registered under the CNL.

1.59 Views received from stakeholders during the Review indicate that the implementation of the CNL and access to CCUs has been welcomed by the cooperatives sector and that there is now a greater ability to access capital for such organisations, although the regime for the issue of CCUs is immature and untested due to the low volume of issuance to date. As such, State and Territory cooperatives were not seeking a mechanism for raising capital through the Corporations Act.[32]

PRINCIPLES GUIDING THE REVIEW

1.60 The Review has considered both regulatory and legislative reforms.

1.61 Valuable and immediate solutions that can be accomplished over the short-term include regulatory reforms to allow mutually owned ADIs to directly issue an appropriate capital instrument and an improvement in regulatory processes.

1.62 A review of the CA demutualisation provisions, the development of a sector-wide "mutual capital instrument" and the creation of a legal definition of a "mutual enterprise" are changes that will require further consultation and a greater allocation of time and resources.

1.63 However, while continued progress towards immediate solutions is both attractive and necessary, the Review maintains the equal importance of developing long-term, sustainable solutions. Progress towards immediate solutions should not be delayed on the basis that long-term, sustainable solutions are being considered.

31 See also paragraphs 2.48 to 2.54 of the Senate Report.

32 However, submissions were received regarding the duplication of the disclosure regimes which can apply to the issue of CCUs and other securities – see paragraphs 5.28 and 5.29.

CHAPTER 2: DEFINITION OF MUTUAL

PURPOSE OF A DEFINITION

WHY IS A DEFINITION NEEDED?

2.1 The primary purpose for inserting a definition of "mutual enterprise" in the Corporations Act (Recommendation 4 of the Senate Report) is practical. If the Corporations Act is to be amended to define the role of directors in "mutual enterprises" (Recommendation 5) and/or to provide for access to a broader range of capital raising and investment opportunities (Recommendation 17), then it is necessary to define what constitutes a "mutual enterprise" for these purposes.

2.2 This proposition is straightforward, but it also raises some broader issues which are outlined in some submissions to the Review. For example, a supplementary submission from BCCM states:[33]

> *"the very fact that mutual companies are not defined in law is indicative of a wider problem that the sector faces. It is not merely that the lack of recognition irritates mutuals, but rather that this has a real impact on the day to day business of mutuals"; and*
>
> *"the lack of a definition amplifies problems that stem from a cultural view of what is a 'normal' company. It means that mutuals are not considered when other corporate rules are devised and implemented, and that there is a systemic 'bias' against the sector."*

2.3 Australian Unity further submitted that:

> *"in addition to enhancing competition and promoting growth, a clear and legislated framework for mutuals [including an appropriate definition] would provide an incentive for community groups and service-minded individuals to establish new mutuals with long-term, community service objectives. The potential for valuable economic activity to be pursued in areas, where other corporate forms may have limitations, is significant and includes a range of human services arenas, including indigenous community enterprise and social service activities."*[34]

2.4 As noted in paragraphs 1.46 to 1.52, mutuals are not explicitly defined in the Corporations Act and, apart from the CA demutualisation provisions, the Corporations Act does not distinguish between mutuals and non-mutuals. ASIC does not have a mandate of promoting or protecting mutuality. As a result, mutuals are easily characterised as marginal, and regulators may become ambivalent to mutuals.

33 BCCM supplementary submission to the Review, page 1.

34 Australian Unity submission to the Review, page 3.

NORMALISATION

2.5 In roundtable meetings, a view was expressed on several occasions that mutuals felt pressured to "normalise" – to become a "normal" company.

2.6 The process of "normalisation" is discussed in the March 2012 Report of the UK Ownership Commission *Plurality, Stewardship & Engagement* (UK Ownership Report).[35] The executive summary stated:[36]

> *"The British private sector is dominated by a single company organisational form, namely the [Public Limited Company (PLC)]. While the PLC has many advantages that should be celebrated, it has become the default corporate organisational form for risk-taking investors, financiers, regulators and government, to an extent that reduces opportunities for other ownership forms to grow and prosper. Plurality of ownership forms should be viewed as an economic good in its own right, increasing both choice and the variety of corporate forms available for varying business models and their investors while spreading risk more effectively ….*
>
> *The Commission is also concerned that PLC share ownership is increasingly influenced by short-term transactional imperatives, generated partly by an increased number of intermediaries in the chain between assets and their ultimate owners. We are anxious that there is evidence that short termism is increasing, making it harder for Britain to have strong companies where long termism is central to the business model, like those dependent on an expensive infrastructure or long term product development ….*
>
> *The regulatory and financial focus upon the PLC hides the degree of ownership plurality that Britain already has. By failing to recognise alternative ownership forms as they do exist, policy-makers fail to offer them the supporting infrastructure that they need to grow."*

2.7 Similar observations could be made about Australian companies limited by shares.

2.8 Regulatory responsibility for TFIs (building societies, credit unions and friendly societies) was transferred to the Commonwealth in 1999. Each TFI was taken to be registered as a company under the then Corporations Law.[37]

2.9 As a result, the TFIs ceased to be regulated by specific sector legislation (as remains the case in the United Kingdom and many other foreign jurisdictions), but as mutual companies were regulated by the same legislation as non-mutual companies. It is arguable that this change has accelerated process of "normalisation", particularly as the opportunity was not taken in 1999 to define a "mutual company" and set out how the then provisions of the Corporations Law should apply to "mutual companies". Rather, the focus was on demutualisation. The failure to define a "mutual company" could be seen as an unintended consequence of the transfer of regulatory responsibility to the Commonwealth.[38]

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35 Employee Ownership Australia Limited submission to the Senate Committee, Attachment 1.

36 Page 9 of the report.

37 A TFI could elect to become a company (public or proprietary company limited by shares, guarantee or both shares and guarantee) from two or more choices set out in the table in section 3 of Schedule 4 to the Corporations Law as introduced by the FSR Act.

38 Although non-prudentially regulated mutuals were registered under the Corporations Act prior to 1999, some submissions to the Review indicate that even those mutuals have been impacted by the process of "normalisation".

2.10 In her submission,[39] Ms Ann Apps (Lecturer, Newcastle Law School, University of Newcastle) makes a similar point to that made in by the UK Ownership Commission:

> *"If the Corporations Act was purely an enabling piece of legislation, this lack of express definition and legal identity may not have had such an adverse impact on the co-operative and mutual sector. So long as co-operatives and mutuals maintained an internal governance structure that was consistent with a member owned or mutual business, arguably it did not matter what legal vehicle they chose for incorporation and registration.*
>
> *However, the Corporations Act is more than a piece of enabling legislation for various types of business association. The legislation is mainly concerned with regulatory control of the corporate and financial services markets.*
>
> *The problem for the co-operative and mutual sector is that most regulatory controls are tailored to remedy or respond to the behaviour of a particular type of governance structure – that is, one where the key stakeholders are shareholders who are seeking to maximise their return on investment.*
>
> *Mutuals and co-operatives have a different type of governance structure, their key stakeholders are members and their primary objective is to seek maximum value from their transactional relationship (as customers or suppliers) with the business."*

2.11 Ms Apps goes on to quote Professor Ross Grantham who argues that:

> *"the Corporations Act, 2001 has moved from an essentially private law substantive rights model - to a model that seeks to regulate a company through the prescription of processes and practices by which corporate decisions might be made and by which the procedural correctness of those decisions is assured."*[40]

A MUTUAL IDENTITY

2.12 In some respects, the argument for inserting a definition of "mutual enterprise" in the Corporations Act is an argument for recognition of the separate legal identity of mutuals:[41]

- to identify the key features of mutuals;
- to provide clarity for stakeholders, including regulators, to distinguish mutual companies from investor-owned, non-mutual companies;
- to improve capacity to promote the distinct identity, size, scope and contribution of the mutual sector;
- to help courts and regulators make decisions regarding how legislation and regulation should be applied to mutuals in particular circumstances;
- to assist in promoting the model as a competitive alternative to investor ownership;

39 Submission to the Review, page 2.

40 *The Proceduralisation of Company Law* (2015) 43 *Federal Law Review* 233.

41 The following bullet points are extracted and/or adapted from several submissions to the Review (including the submissions from Ms Ann Apps and COBA).

- where appropriate, to adapt elements of the Corporations Act and other legislation in the future to more appropriately apply to mutuals; and
- to avoid the risk of engaging in misleading and deceptive conduct.

2.13 The Senate Committee reached a similar conclusion:

> *"The committee is of the view that for the sector to be recognised and actively developed, it requires a concomitant regulatory structure. Being defined in law is a crucial step on the path to the sector being recognised more broadly."*[42]

2.14 Many of the recommendations of the Senate Committee address the need for recognition of the separate legal identity of mutuals (as well as the cooperatives and mutuals sector more broadly). A reversal of the process of "normalisation" referred to in preceding paragraphs of the Review.

2.15 If a mutual is a distinct type of legal identity, the need for a separate regime for the issue of securities to raise capital becomes clearer. Other advantages of a separate regime are discussed in Chapter 4.

2.16 A significant majority of the submissions to the Review supported the inclusion of a definition of "mutual enterprise" (or a similar term) in the Corporations Act.

IS A DEFINITION NECESSARY?

2.17 The contrary view that it is not necessary to insert a definition of "mutual enterprise" (or a similar term) in the Corporations Act is based on two presumptions. First, that the current provisions of the Corporations Act possess sufficient flexibility to address the capital raising needs of nearly all "mutual enterprises". Second, that the directors' duties provisions in the Corporations Act are flexible, principle based provisions that adequately cater for all business structures.

2.18 These presumptions will be discussed further in Chapters 4 and 5. The balance of this Chapter proceeds on the basis that it may be necessary or desirable to insert a definition of "mutual enterprise" (or a similar term) in the Corporations Act.

A WORD ABOUT TERMINOLOGY

2.19 The Senate Report proposed inserting a definition of "mutual enterprise" in the Corporations Act. The use of the phrase "mutual enterprise" reflects the broad focus of the Senate Report on cooperatives and mutual enterprises generally, not just mutuals registered under the Corporations Act.

2.20 If a definition is to be inserted in the Corporations Act it is preferable that the definition be clearly limited, and understood to be limited, to companies registered under the Corporations Act.[43] Many submissions to the Review supported alternative terms: an "incorporated mutual company" or "mutual company". Both terms are preferable to "mutual enterprise".

42 Paragraph 3.48 of the Senate Report.

43 The definition would not apply to cooperatives regulated under State or Territory law which carry on business in States or Territories other than their home jurisdiction and are registered as corporations under Part 5B.2 of the Corporations Act.

SCOPE AND CONTENT OF A DEFINITION

DIVERSITY AND DIFFICULTY

2.21 The Senate Report does not adopt a single definition for either a "cooperative" or a "mutual", but rather refers to a range of descriptions and definitions used for varying purposes. Evidence before the Senate Committee frequently used the terms cooperative, mutual or member-owned firm interchangeably. The following quotes from the Senate Report illustrate the similarity in the two terms:

> *"The defining characteristic of a co-operative is that it is owned by their members and acts in the interests of their members, rather than to provide benefit to shareholders or investors"*[44]

> *"… the distinguishing characteristic of a mutual organisation is that it is owned by its members, and run exclusively for their benefit, rather than for the benefit of outside investors"*[45]

2.22 The Senate Report, and the submissions to the Senate Committee and the Review, highlight the diversity of the mutual sector. There are inherent difficulties in formulating a definition to be included in legislation which is appropriate to the cover the broad range of mutuals registered under the Corporations Act.

2.23 While the seven principles advocated by the ICA and included in section 10 of the CNL may also be appropriate to guide how mutuals should operate,[46] they are not appropriate as the basis for a definition to be included in the Corporations Act.

2.24 A diversity of views as to the content of a definition of "mutual enterprise" (or a similar term) were contained in submissions to the Review. For example, Heritage Bank stated:

> *"There is currently no separate national legislative framework for mutual enterprises within Australia. The lack of a fundamental reference point to legislatively define what a mutual is has resulted in a plethora of corporate structures emerging, all of which justifiably see themselves as 'mutual' in nature. Finding commonalities across these entities is not without challenges, but best served via changes to the Corporations Act using a principles based approach designed to encapsulate the diversity of the sector. Heritage would recommend including at least four categories within a definition of 'mutual enterprise', flexible enough to incorporate the structures used by mutual ADIs, other APRA regulated mutual institutions, non-prudentially regulated mutual enterprises and state based mutual entities seeking to operate across state jurisdictions.*

44 Paragraph 2.8 of the Senate Report.

45 Paragraph 2.16 of the Senate Report.

46 However, if the Corporations Act is amended to include new provisions relating to "mutual companies", then further consultations should be undertaken as to whether the inclusion of a provision similar to section 11 of the CNL is necessary or desirable.

Legislative change requires careful thought around what it means to be a mutual business so as to minimize unintended consequences. ….. In Heritage's view the key considerations as to what satisfies a mutual enterprise should centre around:

a. A definition of mutual ownership structure, in particular formal recognition of how a mutual is governed, that is, one member = one vote; and

b. The need for a constitution to effectively capture the purpose underpinning a mutual operation, in particular recognizing cooperative pursuit of outcomes that align with the interests of the membership base. …..

Together these principles capture the member-based ethos that sets mutuals apart from listed counterparts without being overly prescriptive about the way in which these requirements are implemented in practice."[47]

2.25 BCCM and COBA, as peak representative bodies for the mutual sector, have acknowledged the complexities of defining a "mutual enterprise" (or a similar term):

- BCCM noted that the definition should be permissive and based on the key ownership features of mutuals, and not conflict with RG147 nor the ATO definition of mutuality for taxation purposes;[48] and
- COBA proposed that the Review recommends that the Government agree in-principle to insert a definition of "mutual enterprise" in the Corporations Act and that this definition be determined in consultation with the mutual sector.[49]

POSSIBLE APPROACHES

2.26 The content of a definition was also a significant focus in the roundtable meetings. In a supplementary submission, BCCM outlined two possible approaches to defining a "mutual enterprise" (or a similar term):

- first, to create a list of types of firms (for example, the unlisted TFIs subject to the CA demutualisation provisions); and
- second, to define the nature of a mutual.[50]

A third approach would be combine the two approaches: to define the nature of a "mutual enterprise" (or a similar term) in the Corporations Act, and allow clarity to provided (and uncertainties resolved) through allowing the Corporations Regulations to provide that specific types of companies or companies having specific characteristics (or even named companies) were a "mutual" (as defined).

47 Heritage Bank revised submission to the Review, pages 3-4. Part of the text omitted from the quote refers to incorporating a control capping the quantum of investor share ownership stakes in a mutual. This proposal is referred to in paragraph 4.31.

48 BCCM submission to the Review, page 8.

49 COBA submission to the Review, page 5.

50 BCCM supplementary submission to the Review, page 3-4.

2.27 As discussed in paragraphs 3.50 to 3.76, one of the major difficulties with the CA demutualisation provisions and RG147 is the lack of clarity and uncertainty as to the operation of the provisions and the exercise of ASIC's discretionary power to exempt a mutual from the provisions in certain circumstances.

It is essential that any definition of a "mutual enterprise" (or a similar term) in the Corporations Act be clear and concise so that it can be easily and quickly determined whether an entity is, or is not, a "mutual" as defined. The definition must produce greater certainty, not more uncertainty.

2.28 Further consultation is required on the detailed content of a definition of a "mutual enterprise" (or a similar term), although the core of any definition must be a recognition of the one member, one vote governance principle.[51] The extent to which other matters should also be included in the definition requires further analysis and consultation. Other matters include:

- the need for a mutual's constitution to clearly state the purpose underpinning the mutual;
- the need for the constitution to include an acknowledgement from members that the best interests of the mutual is to be determined by reference to the stated purpose and/or the interests of members as recipients of the goods or services provided by the mutual (rather than the maximisation of profits);
- the extent (if any) to which a person must be a member of a mutual to be a recipient of goods or services provided by the mutual (that is, a customer); and
- restrictions on the payment of dividends and the distribution of surpluses upon the mutual being wound up.[52]

2.29 There was also a consensus during the roundtable meetings that any definition of a "mutual enterprise" (or a similar term) should not force an entity to become a mutual if it wished to remain subject to the Corporations Act as a non-mutual. Any change to the Corporations Act should not be mandatory, but permit an entity which satisfied the requirements of the definition to elect to be a mutual as defined.[53]

2.30 Further consultation is also required as to whether certain types of entities should be excluded from the definition (or from electing to be a mutual as defined). For example, trustees of member owned superannuation funds[54] and entities registered with the ACNC.[55]

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51 The Corporations Regulations could be used to provide guidance on how this governance principle was to be applied, particularly in the circumstances discussed in paragraphs 63-69 of RG147.

52 See also the related matters discussed in paragraphs 56-62 of RG147. In addition, a few participants in the roundtable meetings raised the question of "asset locks" prohibiting the distribution of surplus to members.

53 A process of electing to no longer be a mutual should also be included. In the case of unlisted TFIs, such a process would require compliance with the CA demutualisation provisions (or any new provisions enacted in substitution for them – see Review recommendation 5 in paragraph 3.74).

54 Consideration is required as to whether the structure of member owned superannuation, and the duties owed to the members of those funds, would be inconsistent with the requirements of the definition and (if applicable) the seven principles advocated by the ICA.

55 In this context, it is noted that entities registered with the ACNC are not required to comply with all the provisions of the Corporations Act for so long as they are registered with the ACNC (see section 111L of the Corporations Act). The ACNC is the national regulator of Not-for-profits which have a charitable purpose. Some Not-for-profits may have a purpose which benefits the community, but which is not a charitable purpose at law.

A CAREFUL APPROACH IS REQUIRED

2.31 Many submissions[56] noted that any change to the Corporations Act to include a definition of "mutual enterprise" (or a similar term) needs to be carefully considered to minimise unintended consequences.

2.32 The potential complexity of amending the Corporations Act to include a definition of "mutual enterprise" (or a similar term), and the risk of unintended consequences, have been matters of concern to ASIC. It is accepted that that these are valid concerns, particularly if the intention of amending the Corporations Act is to determine which provisions of the Corporations Act that currently apply to a mutual as company (in the same way as the provision applies to a non-mutual) should apply in a different way, or not at all, to a "mutual enterprise" (or a similarly defined entity).

2.33 However, that is not the primary objective of those cooperatives and mutuals which have advocated for change.[57] The primary objective is much more confined – to enable mutuals to issue "mutual capital instruments" to raise investment capital from their members and external investors.[58] This is a much less complex task, with the risk of fewer unintended consequences. Indeed, the complexity of the task is considerably less than many reforms to Australian corporations law which have been undertaken over the past 20 years.

2.34 A secondary objective is a review of the application of other provisions of the Corporations Act to a "mutual enterprise" (or a similarly defined entity), but this is less urgent and can be considered over time.[59]

2.35 It would be a pointless task to define "mutual enterprise" (or a similar term) in the Corporations Act unless the definition had a purpose (for example, to determine which companies could issue "mutual capital instruments" or similarly defined securities).

2.36 Recommendation 17 of the Senate Report – that the Government examine proposals to amend the Corporations Act to provide cooperatives and mutuals with a mechanism to enable them access to a broader range of capital raising and investment opportunities – is discussed in Chapter 4.

2.37 The Review's recommendation regarding Recommendation 4 of the Senate Report – that a "mutual enterprise" be explicitly defined in the Corporations Act and its associated regulations – see Review recommendation 9 in paragraph 4.25.

56 For example, the submission from Heritage Bank quoted in paragraph 2.24.

57 A confidential submission to the review advocated that attention should be given to (alleged) deficiencies in the governance practices of mutuals (primarily mutually owned ADIs), as "a proper public interest "quid pro quo" balance to the granting of new legal or regulatory capital access benefits". Fourteen changes to the Corporations Act were suggested, but none directly related to overcoming the barriers which currently impede cooperatives and mutuals from accessing capital. The Review received no other submissions on the (alleged) deficiencies and, as a result, the Review did not consider the merits of the suggested changes to the Corporations Act.

58 BCCM submission to the Review, page 5.

59 Recommendation 5 of the Senate report and possible amendments to the law relating to the duties of directors of mutuals, and a staged approach to changes to the Corporations Act, are discussed further in paragraphs 5.2 to 5.12.

CHAPTER 3: CAPITAL FOR PRUDENTIALLY REGULATED MUTUALS

OVERVIEW

3.1 Whether regulatory and legislative barriers currently impede cooperatives and mutuals from accessing capital, the significance of those barriers and whether there should be regulatory and/or legislative changes to improve access to capital for such enterprises is separately considered for different types of Commonwealth registered cooperatives and mutuals considered by the Review:

- mutuals registered as companies under the Corporations Act and prudentially regulated by APRA;
- other mutuals registered as companies under the Corporations Act; and
- cooperatives regulated under State or Territory law which carry on business in States or Territories other than their home jurisdiction.

Whilst there are many similarities in the issues and challenges faced by the different types of cooperatives and mutuals, this Chapter considers the issues and challenges for mutuals prudentially regulated by APRA, and Chapters 4 and 5 consider the issues and challenges which face mutuals and cooperatives more generally.

MUTUALS PRUDENTIALLY REGULATED BY APRA

3.2 APRA oversees banks, building societies, credit unions, general insurers and reinsurance companies, life insurers and friendly societies, PHIs and most members of the superannuation industry. Mutually owned ADIs, mutual friendly societies and mutual PHIs form part of APRA's regulated population.

3.3 Whilst various aspects of APRA's prudential framework apply across multiple industries, the key capital standards are industry specific. The focus of the following discussion is on the capital standards which apply to mutually owned ADIs. The capital requirements which apply to mutual friendly societies and mutual PHIs are briefly discussed in paragraphs 3.37 to 3.40.

CAPITAL STANDARDS FOR MUTUALLY OWNED ADIS

3.4 Capital is the cornerstone of an ADI's financial strength. It supports an ADI's operations by providing a buffer to absorb unanticipated losses from its activities and, in the event of problems, enables the ADI to continue to operate in a sound and viable manner while the problems are addressed or resolved.[60]

60 Paragraph 8, Prudential Standard APS 110 - Capital Adequacy.

3.5 APRA's approach to capital adequacy is based on the risk-based capital adequacy framework in the Basel Committee on Banking Supervision's publications, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (Basel II), revised in June 2006 and *A global regulatory framework for more resilient banks and banking systems* (Basel III), revised in June 2011.

3.6 *Prudential Standard APS 111 - Capital Adequacy: Measurement of Capital* (including 11 attachments) (APS 111) sets out in detail the characteristics that an instrument (or other forms of capital) must have to qualify as regulatory capital for an ADI and the various regulatory adjustments to be made to determine total regulatory capital. Regulatory capital consists of the following categories:

- Tier 1 Capital (going-concern capital),[61] which comprises Common Equity Tier 1 Capital (CET1) and Additional Tier 1 Capital (AT1); and
- Tier 2 Capital (gone-concern capital).[62]

The key instruments and other forms of capital which comprise regulatory capital are set out in table 2.

TABLE 2: KEY SOURCES OF REGULATORY CAPITAL

CAPITAL TIER	KEY SOURCES OF CAPITAL AVAILABLE TO ADIS (NON-MUTUAL)	KEY SOURCES OF CAPITAL AVAILABLE TO MUTUALLY OWNED ADIS
Common Equity Tier 1 (CET1)	• Retained earnings Ordinary shares Certain reserves Less regulatory adjustments including certain intangible assets, capitalised expenses and software, and investments and retained profits in some subsidiaries	• Retained earnings No direct issue of mutual equity interests (MEIs) currently permitted Certain reserves Less regulatory adjustments including certain intangible assets, capitalised expenses and software, and investments and retained profits in some subsidiaries
Additional Tier 1 Capital (AT1)[63]	Qualifying hybrid securities (write-off and convertible into ordinary shares)	Qualifying hybrid securities (write-off and convertible into MEIs)
Tier 2 Capital[64]	Qualifying subordinated debt (write-off and convertible into ordinary shares)	Qualifying subordinated debt (write-off and convertible into MEIs)

3.7 Prudential Standard APS 110 - Capital Adequacy (APS 110) requires ADIs to maintain minimum ratios of capital to risk weighted assets for:

- CET1, a minimum ratio of 4.5 per cent;
- Tier 1 Capital (that is, the aggregate of CET1 and AT1), a minimum ratio of 6.0 per cent; and

61 'Going-concern capital' refers to capital against which losses can be written off while an ADI continues to operate. Going-concern capital will also absorb losses should the ADI ultimately fail.

62 'Gone-concern capital' refers to capital that would not absorb losses until an ADI is wound up or the capital is otherwise written off or converted into ordinary shares or mutual equity interests.

63 Paragraph 27, APS 111 provides that ATI comprises high quality components of capital that satisfy the four essential characteristics: provide a permanent and unrestricted commitment of funds; are freely available to absorb losses; rank behind the claims of depositors and other more senior creditors in the event of winding up; and provide for fully discretionary capital distributions.

64 Paragraph 27, APS 111 provides that Tier 2 Capital includes other components of capital that, to varying degrees, fall short of the quality of Tier 1 Capital but nonetheless contribute to the overall strength of an ADI and its capacity to absorb losses.

- Total Capital (that is, the aggregate of Tier 1 Capital and Tier 2 Capital), a minimum ratio of 8.0 per cent.

3.8 APRA can also require an ADI to:

- meet prudential capital ratios above the minimum capital ratios; and
- hold additional CET1 as conservation and countercyclical buffers above minimum capital requirements.

3.9 There are three other features of the capital standards to be noted at this point:

- first, the concept of risk weighted assets - the amount of an ADI's assets and off-balance-sheet exposures, weighted according to risk,[65] which is used in calculating the capital ratios for an ADI;
- second, as noted in Table 2, the capital standards require certain adjustments and amounts to be deducted from CET1;[66] and
- prudential requirements are increasingly related to CET1 rather than total capital. For example, APRA's proposed large exposures framework measures large exposures relative to CET1 rather than total capital.

3.10 An important effect of risk weighting assets is that to invest, innovate, grow and compete, an ADI must be able to increase its capital, particularly CET1. Professor Kevin Davis noted in his submission to the Review:

> *"Australian mutual deposit takers, such as mutual banks, credit unions and building societies (mutual ADIs) face significant restrictions on their ability to grow and compete with joint-stock banks because of their inability to access external capital. To increase capital to meet regulatory requirements associated with growth they need to generate surpluses from their activities, which can then be retained as additions to capital. But to generate a higher surplus involves widening the interest rate spread between borrowers and depositors (or generating more fee income) which inhibits the use of their services by customers and their growth rate. Consequently, there is a limit to the growth rate they can achieve without reducing capital adequacy."*[67]

3.11 The impact of the regulatory adjustments required by the capital standards, particularly in relation to the deduction of the costs of technology and infrastructure investment, was noted in many submissions to the Review. For example:

> *"To maintain relevance and competitiveness in the Australian banking market, we have recently begun a digital transformation project to implement a new generation of technology. The material cost of this project will be deducted from our CET1. Given our inability to raise CET1, we have been forced to restrict lending growth over the medium term to maintain capital levels above prudential requirements."*[68]

65 Risk-weights are based on credit rating grades or fixed weights broadly aligned with the likelihood of counterparty default. Some assets are given a risk weight of zero (for example, claims on the Reserve Bank of Australia), whereas other assets are given a risk weight of as much as 150%. Further information on risk weights is set out in *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk.*

66 Attachment D, APS 111.

67 Professor Kevin Davis submission to the Review, page 1.

68 Qudos Bank submission to the Review, page 2.

> *"The inability to issue capital is compounded by the current prudential rules relating to investments in technology. Under the APRA capital management regime all investments of an 'intangible' nature are a deduction from capital for prudential capital purposes. Therefore capitalized technology costs associated with investments in software licensing and consultancy are effectively funded entirely from core capital. Transforming into a digitally-led business requires significant investment. Funding that investment out of retained earnings alone is a massive challenge for mutual ADIs. The scale of investment required puts the sector at a huge disadvantage compared to the listed banks, which have already used their much more flexible access to capital to invest in technological transformations."*[69]

3.12 CET1 also forms the basis of the key adjusted capital ratios used by rating agencies. Rating agencies highlight capital-issuing restrictions on mutuals as negatives. Moody's notes that one COBA member "does not have the flexibility to raise additional common equity" while another COBA member has "limited ability to raise additional regulatory capital."[70]

3.13 The 2014 Financial System Inquiry (FSI) endorsed the benefits of a strongly capitalised banking system and recommended that APRA set capital standards such that capital ratios of ADIs are 'unquestionably strong'.[71]

3.14 On 19 July 2017 APRA released an Information Paper *Strengthening banking system resilience – establishing unquestionably strong capital ratios* outlining APRA's conclusions with respect to the quantum and timing of the capital increases required for ADIs to achieve unquestionably strong capital ratios.[72] In summary, the four major banks will need to have CET1 capital ratios of at least 10.5 per cent to meet the 'unquestionably strong' benchmark, and for other ADIs (including mutually owned ADIs) the effective increase in capital requirements to meet the 'unquestionably strong' benchmark will be around 50 basis points. All ADIs are expected to meet the new benchmarks by 1 January 2020.

THE IMPORTANCE OF CET1

3.15 It should be apparent from this brief description of APRA's capital standards that the majority of an ADI's regulatory capital must consist of CET1.

3.16 CET1 is the highest quality component of capital. It is subordinated to all other elements of funding, absorbs losses as and when they occur, has full flexibility of dividend payments and has no maturity date. In order qualify as CET1, an instrument (or other form of capital) must fully satisfy all the following characteristics:

- provide a permanent and unrestricted commitment of funds;
- are freely available to absorb losses;
- do not impose any unavoidable servicing charge against earnings; and
- rank behind the claims of depositors and other creditors in the event of winding-up of the ADI.

69 Heritage Bank revised submission to the Review, page 1.
70 COBA submission to the Review, page 10.
71 Chapter 1, Recommendation 1. The final report of the FSI is available on the FSI website.
72 The Information paper is available on the APRA website.

3.17 Under APRA's previous capital standards implementing Basel II, mutually owned ADIs had an ability to issue instruments which qualified for inclusion in the then highest quality component of capital. However, under the current capital standards implementing Basel III, they are unable to issue instruments which qualify as CET1.

3.18 Non-mutually owned ADIs can issue ordinary shares which will usually satisfy all the requirements for CET1.[73] All mutually owned ADIs are registered under the Corporations Act as companies limited by shares, or by both shares and guarantee, and can issue shares. However, they cannot issue shares which satisfy all the requirements for CET1.

3.19 The benefits of CET1 capital issue for mutually owned ADIs is summarised in Table 3 which is adapted from the attachment *CET1 instruments for mutual ADIs* to COBA's submission to the Review.

TABLE 3: BENEFITS OF CET1 ISSUE CAPACITY FOR MUTUALLY OWNED ADIS

ACTIVITY	EXPLANATION	OUTCOME
Meet specific CET1 buffers (countercyclical and capital conservation)	Buffers specifically require CET1 capital	Greater ability to meet prudential requirements
Grow assets for capital constrained ADIs	Allows increases in capital at a faster rate than profit growth	Increased competitive capacity to take diversification opportunities
Grow while maintaining the same capital buffer	ADIs who wish to hold higher capital can grow without diluting their capital reserves	Retain a similar level of financial stability
Grow without having to manage multiple capital types	CET1 meets all capital requirements while AT1 and Tier 2 Capital are more complex	Simplifies capital management
Increase capital raising flexibility	MEIs currently can only be issued on conversion of AT1 or Tier 2 Capital	Increased capital raising flexibility by demonstrating existence of MEIs
Modernise IT systems and software	Offsets the CET1 deduction	Reduced operational risk and more efficient operations
Acquire intangible assets	Offsets the CET1 deduction	Expands business opportunities and encourages innovation
Recover from adverse events	Issuance can replenish capital	Greater recovery ability and a "safety net" for taking calculated risks
Undertake strategic business development initiatives	Offsets the CET1 deduction	Better prospects and increased competitive capacity
Reduce regulatory uncertainty	As the highest form of capital, CET1 are unlikely to fall outside regulatory capital requirements	Greater certainty around capital management. Reduced need to undergo costly capital replacement processes

73 Attachment B, APS 111.

3.20 The need for mutually owned ADIs to be able to issue additional capital, particularly CET1, was a common in theme in submissions to the Review. For example:

> *"The Australian Bankers' Association (ABA) …. recognises the critical importance of cooperatives, mutuals and member-owned firms in the Australian economy and welcomes your appointment to progress meaningful reforms to an important industry sector which contributes around 7 per cent of Australia's GDP. The ABA is a strong supporter of the recommendations arising from the 2015 Senate Economics References Committee inquiry into cooperatives, mutuals and member-owned firms. Of particular interest to the ABA are recommendations 16 (Capital Raising) and 17 (Amendments to the Corporations Act). The ABA would strongly support the continued progression of these two recommendations as the findings underpinning them highlights impediments to innovation, growth, and competition within the banking industry, barriers which can be removed."*[74]
>
> *"Greater access to regulatory capital means that customer-owned banking institutions are able to grow more quickly and undertake important investments, while remaining well capitalised. This allows our sector to write more loans and provide better quality services to current and prospective members. This increases competition in the banking sector."*[75]
>
> *"The ability to issue both Tier 2 and Tier 1 capital is key in Bank Australia reaching its potential and having the scope and confidence to invest in initiatives that support this growth such as technology and capability."*[76]
>
> *"Whilst TMBL has historically relied solely on Retained Earnings to generate capital, we see a need to prove our capability in capital raising to build flexibility into our balance sheet management and enhance market confidence; as we build the organisations scale, scale that is required to maintain our efficiency, technology development and cover regulatory compliance costs."*[77]
>
> *"Limitations on the ability of mutuals to issue additional capital also restricts the sector's ability to invest in innovation and growth and, over time, could lead to the reduction of consumer choice and competition in the market. ….. The limitations on capital issuance also makes it difficult for us to invest in products and services that will benefit our members and ensure we meet consumers' evolving expectations and maintain our competitiveness with the bigger banks. People's Choice does not enjoy the significant benefits of scale and efficiencies that large banks have, yet we still need the critical technological investment to maintain and advance our member experience through better products and services and to remain relevant and up to date with larger competitors' offerings."*[78]

74 ABA submission to the Review, page 1.
75 COBA submission to the Review, page 9.
76 Bank Australia submission to the Review, page 3.
77 Teachers Mutual Bank submission to the Review, page 1.
78 People's Choice Credit Union submission to the Review, pages 1-2.

3.21 It was further submitted that this need for mutually owned ADIs to be able to issue further capital, particularly CET1, was pressing notwithstanding that the mutually owned ADI sector is highly capitalised. APRA's Information Paper *Strengthening banking system resilience – establishing unquestionably strong capital ratios* noted that most mutually owned ADIs already have capital ratios well in excess of minimum requirements, but that there was considerable variation in capital ratios around the median.[79]

3.22 APRA's Information Paper also noted that many ADIs are more constrained in their ability to raise capital organically, relative to the four major banks. APRA also stated:

> *"However, most of the smallest ADIs, many of whom are mutually owned, already have very high capital ratios and APRA expects that little or no increase in actual capital may be required for the vast bulk of these ADIs."*[80]

However, this was a comment regarding the impact of the proposals in the Information Paper, and not a comment about the need to raise capital to enable mutually owned ADIs to invest, innovate, grow and compete.

3.23 The limitation on mutual financial institutions being able to issue CET1 is not unique to Australia. Mutual financial institutions in other jurisdictions which have implemented Basel III face similar limitations. Regulators in some of those jurisdictions "have found a way to accommodate the mutuals in ways that [Australia] has not."[81] Examples from the United Kingdom, European Union and Canada were referred to in several submissions to the Review. In a supplementary submission,[82] COBA noted:

> *"COBA is not suggesting we directly copy any particular overseas solution but the important lesson from comparable countries is that Australia has fallen behind in terms of giving its mutual banking sector a level playing field with listed banks.*
>
> *Interestingly, in 2012 a Basel Committee team (headed by former APRA Executive General Manager, Charles Littrell) assessed the EC's application of the Basel III framework and made the following observation about the EC's provisions accommodating mutuals:*
>
> *The CRR has modified three of the 14 criteria for application to mutuals and cooperatives. The EC explained that the modifications are necessary to accommodate governing laws for mutuals and cooperative banks in some Member States. This is consistent with the Basel Committee's stipulation that application of the CET1 criteria can take into account the specific constitution and legal structure of non-joint stock companies …. the assessment team found the CRR modifications to limit the CET1 holders' claims and restrict maximum level of distributions both acceptable, but had difficulty with the modification to allow co-operative banks to issue instruments redeemable at the option of the holder and include them as CET1."*

79 Figure 10, Information Paper, page 30.

80 Information Paper, page 35.

81 COBA submission to the Review, page 20 quoting testimony from Mr Pat Brennan, General Manager, Policy Development, APRA before the Senate Committee. Mr Brennan's testimony is available on the Australian Parliament website.

82 COBA supplementary submission to the Review, page 1.

3.24 In summary, mutually owned ADIs seek the ability to issue a CET1 instrument:

- with rights as substantively similar to the rights of holders of ordinary shares issued by non-mutuals so far as is practicable having regard to their responsibilities to members; and
- as quickly and efficiently in a manner which is as close as practicable to, and with no greater restrictions than, the way non-mutually owned ADIs can issue ordinary shares.

3.25 An ability for mutually owned ADIs to issue CET1 will:

- contribute to the strengthening of the banking system and improving financial stability;
- contribute to mutually owned ADIs being able to maintain unquestionably strong capital ratios; and
- facilitate the capacity of mutually owned ADIs to raise capital in the event of problems to enable the mutually owned ADI to continue to operate in a sound and viable manner while the problems are addressed or resolved.

MUTUAL EQUITY INTERESTS

3.26 APRA has been conscious of the difficulties faced by mutually owned ADIs in raising capital. AT1 and Tier 2 Capital[83] includes qualifying hybrid instruments convertible into ordinary shares (in the case of non-mutually owned ADIs) or convertible into MEIs (in the case of mutually owned ADIs).[84]

3.27 MEIs were developed by APRA in consultation with industry to be a capital instrument which could form part of a mutually owned ADI's CET1. The development involved APRA exercising a discretion to make a decision that works best for Australian circumstances whilst remaining in compliance with the Basel III international standards.[85]

83 An AT1 instrument classified as a liability under Australian Accounting Standards must include a provision whereby it will be immediately and irrevocably converted into ordinary shares or MEIs ("bailed-in"), or written off, when the issuing ADI's CET1 ratio falls to or below a prescribed level. In addition, an AT1 or Tier 2 Capital instrument must include a provision under which, on the occurrence of a non-viability trigger event (as defined), it will be immediately and irrevocably converted into ordinary shares or MEIs ("bailed-in"), or written off. See Attachments F and J, APS 111.
In his submission to the Review (pages 4-6), Professor Davis considered whether such capital instruments are, in fact, a good idea as they create problems for mutually owned ADIs. He noted that "because mutual ADIs work on a one member one vote principle and do not make distributions of profits on the minimal amount of contributed member equity, conversion of such bail-in instruments would require the creation of an alternative form of equity instrument." Professor Davis argued for designing contingent capital instruments for mutually owned ADIs which have only a write-down clause.

84 MEIs issued on conversion of ATI or Tier 2 Capital must satisfy the requirements of Attachment K, APS 111.
In his submission to the Review (page 4), Professor Davis noted that "the difficulties in appropriately designing [MEIs] are large and their implications for mutual management and governance unclear" and queried whether MEIs were a feasible option. This view was not supported in other submissions to the Review and seems to overstate the level of difficulty given the other information which was provided to the Review regarding the substantial progress which had been made in designing MEIs.

85 See the discussion in the recent speech *International standards and national interests* by the Chairman of APRA, Mr Wayne Byres, to The American Chamber of Commerce in Australia available on the APRA website.

3.28 As all mutually owned ADIs are registered under the Corporations Act as companies limited by shares, or by both shares and guarantee, MEIs will constitute an interest in the capital, and form part of the (investor) share capital, of a mutually owned ADI.[86] MEIs will be securities for the purposes of the fundraising provisions in Part 6D.2 of the Corporations Act (CA fundraising provisions).

3.29 However, mutually owned ADIs cannot directly issue MEIs under current capital standards. In the most recent *APRA Insight*[87] APRA noted that:

> *"APRA is also working to develop a suitable framework for issuance of Common Equity Tier 1 capital instruments by mutually-owned ADIs, which would meet APRA's prudential expectations for the highest quality of capital. If viable, this may enable mutual ADIs to raise equity directly and enhance their capital management flexibility, which was also [Recommendation 16] of the Senate Economics References Committee's report Cooperative, mutual and member-owned firms. This work is expected to progress to formal industry consultation around the middle of 2017."*

3.30 APRA confirmed to the Review that it will shortly release for consultation a discussion paper and draft prudential standard proposing direct issue of MEIs by mutually owned ADIs, and will relax some of the criteria applying to ordinary shares that conflict with mutually owned ADIs' responsibilities to members. A discussion paper *Common Equity Tier 1 capital instruments for mutually owned ADIs* and draft prudential standard was published by APRA on 26 July 2017, but was not reviewed before the Review was completed.

3.31 APRA also confirmed that public consultation on this proposal will be for a six-week period, and if consultation does not present material, unanticipated matters, finalisation and commencement of the new framework can proceed as soon as possible thereafter.[88] Submissions on APRA's discussion paper are due by 8 September 2017.

3.32 It can be reasonably anticipated that the rights attached to directly issued MEIs will be substantively the same as those already provided for in Attachment K of APS 111 as attaching to MEIs issued on conversion of ATI or Tier 2 Capital.[89]

3.33 The rights attaching to MEIs will be different to the rights attaching to ordinary shares issued by non-mutually owned ADIs reflecting the different corporate structure of a mutually owned ADI. The characteristics of MEIs, and the rights of holders of MEIs, should be clear and concise to allow to MEIs to be readily compared to ordinary shares issued by non-mutuals, and assessed by members and investors.

3.34 A significant majority of the submissions to the Review advocated APRA allowing the direct issue of MEIs.[90]

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86 Paragraph 11 of Attachment K of APS 111 currently requires a mutually owned ADI issuing AT1 or Tier 2 Capital to have a constitution that permits the issue of MEIs and to have obtained all member approvals required by the constitution for the issue of the AT1 or Tier 2 capital and the issue of MEIs on conversion.

87 Available on the APRA website.

88 Even if direct issue of MEIs is permitted under revised capital standards, APRA will rightly retain the ability to approve, or not approve, the issue of MEIs by a mutually owned ADI as part of its overall prudential supervision and oversight of the mutually owned ADI.

89 It is likely there will be some changes to Attachment K of APS 111 in relation to both directly issued MEIs and MEIs issued on conversion of AT1 or Tier 2 Capital.

3.35 Paragraphs 3.2 to 3.34 have considered issues which are particularly relevant to Recommendation 16 of the Senate Report - that APRA set a target date for the outcome of discussions with the cooperative and mutuals sector on issues of capital raising and bring those discussions to a timely conclusion. Whilst a target date has not been set, it seems likely that the objectives of Recommendation 16 will be achieved soon.

REVIEW RECOMMENDATION 1

3.36 Government support (i) the ability of mutually owned ADIs to directly issue CET1 instruments, and (ii) APRA giving priority to the consideration of amendments to its prudential standards to permit them to do so

OTHER PRUDENTIALLY REGULATED MUTUALS

3.37 In the case of mutual friendly societies and mutual PHIs, capital is regulated by APRA through a combination of solvency and capital standards. The capital standards are similar to those applying to ADIs, but do not currently contemplate the issue of mutual equity interests (or similar capital instruments).

3.38 Submissions to the Review were supportive of mutual friendly societies and mutual PHIs being given capacity within APRA's prudential framework to issue instruments that qualify as CET1 and are consistent with the mutual model.

> *"Mutual friendly societies are not permitted under APRA's prudential framework to issue capital instruments that qualify as the highest quality form of regulatory capital: Common Equity Tier 1 (CET1). The only directly-issuable capital instruments that qualify as CET1 are 'ordinary shares'. Mutual friendly societies cannot issue ordinary shares without demutualising."*[91]
>
> *"Like many mutuals, rt group currently can only source working capital from retained earnings."*[92]
>
> *"hirmaa supports Recommendation 16 [of the Senate Report] which recommends that APRA set a target date for the outcome of these discussions, and believes that this will serve as a strong incentive for all parties to engage in and high quality discussions in good faith.*[93]

3.39 However, the need for mutual friendly societies and mutual PHIs to be able to issue CET1 instruments was not as immediate and pressing as the need for mutually owned ADIs to be able to do so.

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90 Some submissions to the Review contained specific suggestions regarding perceived limitations on the provisions of Attachment K to APS 111. See AMG submission to the Review, pages 4-8. These suggestions should be reviewed in the context of APRA's foreshadowed discussion paper and draft prudential standard proposing direct issue of MEIs and submissions made to APRA in response to the discussion paper as appropriate.

91 Friendly Societies of Australia submission to the Review, page 1.

92 rthealth submission to the Review, page 1

93 hirmaa submission to the Review, page 4. hirmaa is the national peak industry body representing 22 not-for-profit, member owned and community based private health insurers.

3.40 Unlike all mutually owned ADIs, not all mutual friendly societies and mutual PHIs have the legal capacity to issue shares – some are registered as companies limited by guarantee. In the case of those mutuals, additional issues arise which are considered in Chapter 4 in the context of equity interests being issued by mutuals more generally.

REVIEW RECOMMENDATION 2

3.41 Government support (i) the ability of mutual friendly societies and mutual private health insurers to directly issue CET1 instruments, and (ii) APRA considering the amendment of its prudential standards to permit them to do so.

STANDARD TERMS

3.42 In both submissions and roundtable meetings comments were made as to the (unacceptable) length of time taken by APRA to approve the terms and conditions of capital instruments.

3.43 In their submission to the Review,[94] COBA noted:

> *"COBA members have experienced unacceptable delays in obtaining decisions from regulators about proposals to issue regulatory capital instruments. This failure of process is a barrier to accessing capital because of the cost in terms of legal and tax advice and the diversion of internal resources over unreasonably lengthy periods.*
>
> *With APRA, COBA members have endured endlessly iterative processes involving different divisions of the regulator. When COBA members seek to address the regulator's initial concerns in their follow-up proposals, members have had experiences where a regulator has, surprisingly, come back with further concerns that were not raised in the initial proposal. This highly iterative process means that COBA members must incur significant costs to pay for the taxation, legal and advisory professionals (as well as the use of internal resources) to continually go over these documents without having any certainty about whether any issue is truly 'closed'.*
>
> *In the most extreme case, one COBA member has been in the process of preparing to issue a capital instrument for almost two years and has encountered lengthy delays in obtaining feedback and approvals from APRA and a lack of support from ASIC."*

3.44 APRA noted that delays also arise because of the time taken by mutually owned ADIs in responding to matters raised by APRA.

3.45 A possible way of reducing the elapsed time from a capital instrument being submitted to APRA for consideration and the point of issue is the development of standard template forms for MEIs, other capital instruments and documentation.[95]

94 Page 17.

95 APRA also suggested that standard template forms would also assist APRA, noting that it was assessing several Tier 2 capital instruments submitted by smaller mutually owned ADIs, which required it to assess differing provisions.

3.46 APRA should be encouraged to develop a mutuals centre of excellence for the assessment of capital instruments proposed to be issued by prudentially regulated mutuals to allow terms and conditions to be assessed as quickly as practicable. APRA and industry should be also encouraged to develop an agreed process, framework and timetable for the submission and assessment of capital instruments proposed to be issued by prudentially owned mutuals.[96]

REVIEW RECOMMENDATION 3

3.47 Government encourage APRA to facilitate the issue of capital instruments by prudentially regulated mutuals by (i) assisting industry to develop standard template forms for member equity interests (MEIs), other capital instruments and documentation, and (ii) developing minimum service standards (including an agreed process, framework and timetable) for the timely assessment of capital instruments proposed to be issued, and accountability mechanisms for the service standards.

3.48 In their submission to the Review,[97] COBA proposed that Government introduce through service charters or Statements of Expectations the minimum service standards and accountability mechanisms referred to in Review recommendation 3(ii). The Review proposes that Government encourage APRA and industry to do so in the first instance.

3.49 In their submission to the Review,[98] COBA further proposed that a corporate diversity clause be introduced into APRA's mandate to ensure that APRA explicitly consider the mutual structure when developing regulation (including an accountability mechanism that requires APRA to assess and report if there are any different impacts on mutually owned ADIs, including if there are none). Logically, any such corporate diversity clause would extend to all prudentially regulated mutuals. The merits (or otherwise) of the inclusion of such a corporate diversity clause was seen to be outside the Review's terms of reference and no detailed consideration was given to the proposal during the Review.

THE DEMUTUALISATION RISK

3.50 As noted in paragraph 1.50, unlisted TFIs (including mutually owned ADIs and mutual friendly societies) must comply with the CA demutualisation provisions. The demutualisation guidelines implemented under section 63(8) of the *Banking Act 1959* (Cth) (Banking Act) have a similar impact to the CA demutualisation provisions, as discussed further in paragraph 3.73.

3.51 The purpose of these provisions is to ensure that "an institution seeking to demutualise [gives] proper regard to members' interests, and [discloses] the [demutualisation] scheme fully" and "[establishes] comprehensive disclosure requirements".[99]

IMPLICATIONS FOR MUTUAL EQUITY INTERESTS

3.52 There is risk that the direct issue of MEIs, or the issue of AT1 or Tier 2 Capital which converts to MEIs upon the occurrence of a loss absorption or non-viability trigger event, could constitute a "demutualisation" under the CA demutualisation provisions. The same risk would arise if mutual friendly societies were able to issue similar capital instruments.

96 Additional comments regarding processes with regulators are contained in paragraphs 5.31 to 5.34.
97 Pages 5, 17 and 18. Similar comments were made in relation to ASIC – see paragraph 3.62.
98 Pages 5 and 19 to 21. Similar comments were made in relation to ASIC – see paragraph 3.63.
99 Explanatory Memorandum for the FSR Act, paragraphs 6.123 and 6.125.

3.53 This may occur even though such issue does not involve a demutualisation in the broadly understood sense of that term.[100] This is recognised in RG147:

> *"A company may trigger the disclosure obligations in Part 5 whether or not they are intending to demutualise. If a change to a mutual company's constitution or a share issue does not, and is not intended to, result in a demutualisation, the company can apply for an exemption …. It will normally do so because it is unnecessary, inconvenient or expensive to comply with the enhanced disclosure requirements."*

3.54 In its policy proposal paper leading up to RG147, ASIC said:

> *"We recognise the need for mutuals to raise capital to compete in the current financial environment, and also recognise the need for capital injection to be rewarded by access to the distributable surplus of a mutual."*[101]

3.55 In their submission to the Review, the Australian Mutual Group (AMG) argued that the issue of MEIs should not trigger the CA demutualisation provisions:

> *"The issuance of equity instruments by a mutual does in theory run counter to the purpose and objects of a mutual enterprise …. it follows that an issue of MEIs could lead to a demutualisation of a mutual ADI. In our view, however, the features of MEIs support mutuality and the issuance of MEIs by a mutual ADI should not trigger its demutualisation under Part 5 of Schedule 4 of the Corporations Act.*
>
> *As a result of the rights attached to MEIs, holders of MEIs support the success of mutual ADIs without compromising member control over decisions or undermining the services provided to members. The issuance of MEIs contributes capital with few conditions or restrictions. As MEIs do not carry the right to vote, each member continues to have an equal say in the conduct of the mutual ADI. Holders of MEIs do not participate in any surplus on a winding up beyond the nominal value of the MEIs, so holders have a limited interest in influencing a winding up. The discretionary nature of MEIs means that holders of MEIs may benefit from a mutual ADI operating profitably, but those distributions would be proportionate to the contribution of capital. Holders have limited scope for influencing the priorities and distribution policies of a mutual ADI without voting rights.*
>
> *Demutualisation is triggered if any of the events in clause 29(1) of Schedule 4 occur (unless an exemption has been issued by [ASIC] under clause 30(2)). This includes where there is a modification of the constitution of a mutual ADI that would have the effect of otherwise varying or cancelling rights so that Part 2F.2 (class rights) of the Corporations Act applies."*[102]

100 The process of conversion into a company owned by shareholders, and existing mutual membership interests being converted into tradeable (and usually publicly listed) shares. See paragraphs 1.34 to 1.39.

101 See COBA submission to the Review, page 8.

102 AMG submission to the Review, pages 3-4.

The submission further argued that, if the issue of MEIs was not already permitted, the constitution of a mutually owned ADI may generally be amended to permit their issue without varying the rights of existing members.[103]

3.56 The conclusion that the constitution of a mutually owned ADI may generally be amended to permit the issue of MEIs without varying the rights of existing members was not necessarily accepted by some other stakeholders. This highlights a key concern expressed in submissions to the Review in relation to RG147 – uncertainty. For example:

> *"ASIC's view on the MEI concept and the demutualisation provisions is set out in its 15 April 2014 letter to COBA (attached). Although this letter provides comfort that ASIC considers that MEI are consistent with the tests of mutuality in ASIC Regulatory Guide 147 Mutuality – Financial institutions (RG147), uncertainty remains for individual entities and particular proposals. More clarity and certainty is needed for customer owned banking institutions that issuing MEIs will not trigger the demutualisation provisions."*[104]

> *"RG147 is ASIC's attempt to provide as much certainty as possible about its use of the exemption power but it would be desirable if mutual friendly societies had greater clarity and certainty that issuing regulatory capital instruments that are consistent with mutuality will not trigger the demutualisation provisions."*[105]

3.57 In both submissions and roundtable meetings comments were made as to the (unacceptable) length of time taken by ASIC to process applications for exemption under the CA demutualisation provisions. However, it is accepted that it is necessary for ASIC to carefully consider the detail of:

- each proposal for a mutually owned ADI to issue MEIs, or AT1 or Tier 2 Capital which converts to MEIs in certain circumstances; and
- any related amendments to the constitution of the mutually owned ADI,

to determine whether an exemption will be granted, and this may take time.

3.58 ASIC accepted that it may not always be easy for an entity to predict with certainty whether ASIC will grant an exemption in a given case, particularly in terms of what constitutional rights already attach to mutual membership and what is being proposed. Whilst early engagement with ASIC may assist, these uncertainties also can adversely impact the timing of any proposed issue.

3.59 However, the following factors suggest changes are required to past practices:

- the importance of mutuals being able to raise capital;
- APRA's foreshadowed discussion paper and draft prudential standard proposing direct issue of MEIs by mutually owned ADIs;

103 As noted in the AMG submission to the Review, a variation of rights is generally considered to be a variation of the rights afforded to the member as a legal matter, not a change that might affect the commercial enjoyment of those rights (see *White v Bristol Airplane Co* [1953] Ch 65 and *Re John Smith's Tadcaster Brewery* [1953] Ch 308).

104 COBA submission to the Review, page 4.

105 Friendly Societies of Australia submission to the Review, page 2.

- the possibility of standard template forms being developed; and
- the comments of ASIC in in its 15 April 2014 letter to COBA.

3.60 ASIC should be encouraged to:

- develop a mutuals centre of excellence for the consideration of applications for exemption under the CA demutualisation provisions to allow exemptions to be considered as quickly as practicable. ASIC and industry should be also encouraged to develop an agreed process, framework and timetable for the submission and consideration of applications; and
- consider, in addition to RG147, the publication of further guidance on the amendments to constitutional rights which it regards as consistent with the tests of mutuality in RG147 (perhaps by way of examples).[106]

REVIEW RECOMMENDATION 4

3.61 Government encourage ASIC to facilitate the issue of capital instruments by unlisted transferring financial institutions by developing minimum service standards (including an agreed process, framework and timetable) for the timely consideration of applications for exemption from the demutualisation provisions in the Corporations Act (and under the demutualisation guidelines under the Banking Act), and accountability mechanisms for the service standards.

3.62 In their submission to the Review,[107] COBA proposed that Government introduce through service charters or Statements of Expectations the minimum service standards and accountability mechanisms referred to in Review recommendation 4. The Review proposes that Government encourage ASIC and industry to do so in the first instance.

3.63 In their submission to the Review,[108] COBA further proposed that a corporate diversity clause be introduced into ASIC's mandate to ensure that ASIC explicitly consider the mutual structure when developing regulation (including an accountability mechanism that requires ASIC to assess and report if there are any different impacts on mutually owned ADIs, including if there are none). Logically, any such corporate diversity clause would extend to all Commonwealth-registered cooperatives and mutuals. The merits (or otherwise) of the inclusion of such a corporate diversity clause was seen to be outside the Review's terms of reference and no detailed consideration was given to the proposal during the Review.

REVIEW OF DEMUTUALISATION PROVISIONS AND RG147

3.64 The risk that the issue of capital instruments could constitute a "demutualisation" under the CA demutualisation provisions has highlighted a further concern – the need for a general review of CA demutualisation provisions and RG147.

106 Additional comments regarding processes with regulators are contained in paragraphs 5.31 to 5.34.
107 Pages 5, 17 and 18. Similar are comments were made in relation to APRA – see paragraph 3.48.
108 Pages 5 and 19 to 21. Similar are comments were made in relation to APRA – see paragraph 3.49.

3.65 It is nearly 20 years since regulatory responsibility for building societies, credit unions, friendly societies and other State and Territory regulated financial institutions was transferred to the Commonwealth in 1999. RG147 was first issued in December of that year.

3.66 Comments were made in submissions and roundtable meetings that more clarity and certainty is needed for mutual ADIs about the types of transactions which are subject to the CA demutualisation provisions. One difficulty is that the provisions define "demutualisation" in a way which includes transactions which do not, and are not intended to, result in a demutualisation in the broadly understood sense of that term.[109]

3.67 The issue for mutual ADIs is not having to comply with the enhanced disclosure regime under the CA demutualisation provisions, but rather the adverse "demutualisation" message that may result from the fact of having to comply in relation to transactions which do not, and are not intended, to convert members' mutual membership interests into tradeable shares. It may be that a change in the terminology used in the provisions (for example, referring to "demutualisation, reorganisations and changes to member rights", rather than just "demutualisation") would itself assist in alleviating this concern.

3.68 In their submission to the Review, COBA proposes that one way to achieve more clarity and certainty is legislative changes to reduce ASIC's discretion and provide greater certainty. COBA noted:

> *"COBA has been generally supportive of the mutuality tests in RG147 but it is now time for a debate within our sector and the wider mutual and co-operatives sector about the features that are the essence of mutuality."*[110]
>
> *"A legislative solution to the uncertainty about what does, and what does not, constitute a demutualisation could be achieved by amending the Corporations Act to insert a definition of a mutual enterprise."*[111]

3.69 In their submission to the Review, Heritage Bank also asked whether some aspects of RG147 are flawed:

> *"More specifically the 'economic relationship test' within RG147 is used by ASIC as a proxy to define the underlying purpose of a mutual entity. The premise underpinning the test is that the rights created for an investor shareholder group should not dilute current member entitlements (undistributed surpluses and annual earnings) because this may threaten the cooperative purpose of the entity. The test effectively defines the assessment of value derived from a member interest in a purely economic context. In addition the definition limits this assessment to a point in time. Philosophically the assumptions underpinning this interpretation are flawed and too restrictive for application across a diverse range of mutual operating structures."*[112]

109 See paragraph 3.54.

110 COBA submission to the Review, page 4.

111 COBA submission to the Review, page 17.

112 Heritage Bank revised submission to the Review, page 7. It is acknowledged that this quote was primarily concerned with the content of a definition of "mutual enterprise" proposed to be included in the Corporations Act.

3.70 ASIC questioned whether legislative amendments to the CA demutualisation provisions, or providing a regulatory safe harbour from the operation of them, could adequately address concerns held by mutuals. ASIC noted that any proposal to modify the CA demutualisation provisions or changes to ASIC's discretion under them should not be implemented without having carefully considered:

- the commercial benefits against the consumer or member interest in receiving sufficient information to assist them in making an informed decision on proposals that will affect their fundamental membership rights; and
- the unintended consequences that legislative amendments might bring about.

3.71 It is accepted that legislative amendments to the CA demutualisation provisions require careful consideration. However, in view of:

- the time which has elapsed since they were introduced;
- changes in the mutuals sector since 1999;
- changes in regulation and supervision over the past 20 years; and
- the issues raised in the submissions to the Review,

consideration of the continued effectiveness of the CA demutualisation provisions, and the exercise of ASIC's discretions under them, would be timely.

3.72 Such consideration should also assess whether the interests of members in a "true" demutualisation involving conversion into a company where members' mutual membership interests are converted into tradeable shares are, or could be, adequately protected by other disclosure regimes in the Corporations Act (for example, the CA fundraising provisions or the provisions relating to schemes of arrangement).

3.73 In addition to the CA demutualisation provisions, the provisions of section 63 of the Banking Act should be considered. Section 63, including the demutualisation guidelines implemented under section 63(8), has a similar effect to the CA demutualisation provisions and applies to mutually owned ADIs (but not other unlisted TFIs). In exercising the powers the Treasurer has delegated to ASIC under section 63, ASIC's approach to both demutualisation regimes is, as far as possible, the same.[113]

REVIEW RECOMMENDATION 5

3.74 Government consider the continued effectiveness of Part 5 of Schedule 4 of the Corporations Act and the demutualisation guidelines implemented under the Banking Act, and the exercise of ASIC's discretions under them, to determine whether any amendments to legislation or regulations are necessary or desirable.

113 See paragraph 70 of RG147.

3.75 The Review also understands that the constitutions of many mutually owned ADIs (and possibly other TFIs) incorporate the CA demutualisation provisions. If this Review recommendation is adopted by Government, then consideration should also be given to the desirability of any amendments to legislation or regulations specifically allowing such constitutions to be amended without such amendments triggering the current or new CA demutualisation provisions.

3.76 If this Review recommendation is adopted by Government, the consideration of the CA demutualisation provisions and the other matters set out in the Review recommendation could proceed separately from other Review recommendations adopted by Government, and need not be completed before the Corporations Act was amended to implement other Review recommendations adopted by Government.

OTHER CONCERNS

3.77 The remaining paragraphs of Chapter 3 consider two other barriers faced by prudentially regulated mutuals in raising capital.

DISCLOSURE MATTERS

3.78 The AMG submission to the Review raises a concern as to whether offers of ATI or Tier 2 Capital (and the MEIs into which they may convert) can be undertaken via an offer information statement (OIS) with reduced disclosure when compared to the disclosure that would be provided for an offer undertaken via a prospectus.[114]

3.79 The AMG submission does not dispute that an offering to retail investors requires the issuer to comply with the disclosure requirements in the CA fundraising provisions.[115] It is submitted that:

- as mutually owned ADIs are often based in regional areas and may be raising only small amounts, it is important for them to be able to raise capital from retail investors in their local communities; and
- assuming all the requirements of the CA fundraising provisions for the use of an OIS are satisfied, then it is unnecessary, inconvenient and expensive to comply with the disclosure requirements for a prospectus.

114 AMG submission to the Review, pages 8-9.

115 In the roundtable meetings, it was also generally accepted by the participating mutuals that it will be necessary to comply with the disclosure requirements in the CA fundraising provisions in relation to the direct issue of MEIs and the issue of equity interests by cooperatives and mutuals more generally.
However, in the AMG submission to the Review (pages 10-11), it was suggested that a special purpose disclosure regime for mutually owned ADIs might be appropriate, given that their activities are confined by their constitutions and the industry is relatively well understood and subject to prudential regulation by APRA. ASIC has significant reservations about this proposal given the likelihood that MEIs or other capital instruments will be offered to unsophisticated investors (rather than advised clients of broker firms) and the risks associated with hybrid securities.

3.80 Consistently with its approach to disclosure in relation to offers of hybrid securities generally, ASIC is not amenable to the use of an OIS for offerings of converting capital instruments (even if the use of an OIS is technically permitted under the CA fundraising provisions). ASIC's view is that prospectus level disclosure is always appropriate for offers of hybrid securities (which would include converting capital instruments).[116]

3.81 A balance needs to be found between providing adequate disclosure to prospective investors and ensuring that the cost of an issue does not become prohibitive for mutually owned ADIs.

REVIEW RECOMMENDATION 6

3.82 Government encourage ASIC to have further dialogue with the affected mutually owned ADIs and industry to determine whether the use of an offer information statement with enhanced disclosure would be appropriate for small scale offers of converting capital instruments.

DEBT / EQUITY RULES

3.83 The AMG and COBA submissions to the Review[117] both raise a technical issue with the debt/equity rules in Division 974 of the *Income Tax Assessment Act 1997* in relation to Tier 2 Capital instruments convertible to MEIs.

3.84 Currently, Regulation 974-135F provides that a "term subordinated note" (as defined in the regulation and which definition most Tier 2 Capital instruments would satisfy) does not cease to be a debt interest for tax purposes (that is, the payment of principal and interest is still effectively non-contingent) merely because it is subject to a "non-viability condition". The difficulty is that the definition of a "non-viability condition" only refers to conversion into ordinary shares. It would not include a Tier 2 Capital instrument that was convertible into MEIs.

3.85 The resulting unfavourable tax treatment (that is, non-deductible interest payments) is a barrier to mutually owned ADIs issuing Tier 2 Capital convertible into MEIs.

3.86 COBA has raised this issue with Treasury and with the office of the Minister for Revenue and Financial Services.

REVIEW RECOMMENDATION 7

3.87 Tax regulations be promptly amended to treat Tier 2 Capital instruments convertible into MEIs in the same manner as Tier 2 Capital instruments convertible into ordinary shares.

116 However, ASIC has confirmed that it has no objection to the use of an OIS for offers of non-converting capital instruments (for example, a direct issue of MEIs, and particularly if standard template documentation is developed), assuming all the requirements of the CA fundraising provisions for the use of an OIS are satisfied.

117 AMG submission to the Review, pages 9-10, and COBA submission to the Review, pages 14-15.

CHAPTER 4: ACCESS TO CAPITAL FOR ALL MUTUALS

INTRODUCTION

4.1 This Chapter considers whether regulatory and legislative barriers currently impede mutuals generally from accessing capital, the significance of those barriers and whether there should be regulatory and/or legislative changes to improve access to capital for mutual enterprises.

4.2 Many of the issues and challenges (but not all of them) faced by mutuals prudentially regulated by APRA and considered in Chapter 3 also are faced by mutuals more generally, but the solutions are not, or cannot, always be the same.

ACCESSING CAPITAL

BARRIERS

4.3 It is convenient to summarise the barriers outlined in the submissions to the Review by adapting the key points in BCCM's submission:[118]

- Mutuals are a strong component of the Australian economy. In an increasingly competitive business environment they need adequate access to capital to fund their growth and development.
- However, the primary way that their capital is raised – through retained earnings – presents challenges to their ability to operate as flexibly as their investor owned competitors do.
- This is a function of the lack of legal options available for mutuals; the Corporations Act does not currently provide for them to issue securities **without risking their mutual status** (my emphasis).
- A lack of capital limits mutuals' growth and the ability to develop new products.
- Mutuals must be able to more easily consider tactical acquisitions.
- Without new capital, many mutuals could be driven into inappropriate corporate forms through demutualisation.
- Mutuals need more alternatives to debt finance.
- Contributions by members of mutuals to capital are untapped in Australia.

118 Pages 2-4. These points were expressed to generally apply to both cooperatives and mutuals.

4.4 The risk to mutual status is a key concern. Many submissions to the Review endorsed the May 2017 joint communique from BCCM and COBA *Raising Capital in Co-operatives and Mutuals*.[119] The joint communique stated (my emphasis):

> *"The structure of co-operatives and mutuals means there are fewer capital raising options than investor owned companies. Capital options need to be consistent with their member-owned business model and which enhance their competitive capacity. Issuing ordinary shares like a listed company would* ***undermine their mutual status and their commitment to serving their member-owners****."*

4.5 This concern was reiterated by BCCM in their publication *Raising New Capital in Mutuals: Removing the barriers to competition and choice* which was attached to their submission to the Review (my emphasis):

> *"In order to raise investment capital for the growth of their business, those mutuals that are permitted to issue shares currently* ***risk diluting their mutual purpose or losing their mutual status*** *by introducing new shareholders with different interest from their members."*[120]

4.6 In addition to the submissions quoted in Chapter 3, by way of further examples:

> *"There is a strong argument in support of Government action to level the 'access to capital playing field' for Cooperatives, Mutuals and Member-Owned Firms such as the [National Health Co-op (NHC)]. By enabling the NHC to rapidly respond to market demands, the Government, at no additional cost, can help deliver significant improvements to the healthcare of all Australians."*[121]

> *"The NRMA believes that a permanent, more flexible and less risky funding option is to allow companies limited by guarantee – such as the NRMA - the ability to issue equity capital. Equity capital would be a key component in raising capital for business expansion when other available sources (such as debt and asset recycling) have been exhausted or are not suitable. Additionally, the repayment and return characteristics of equity capital are inherently more flexible than those in the debt market."*[122]

> *"As Australia's largest cooperative [Co-operative Bulk Handling Limited (CBH)] is pleased to provide a submission in support of the value that co-operatives and mutuals offer the Australian economy and community, and how the removal of those barriers which constrain organisations' access to capital would better allow them to fund their growth and development, to further increase their contribution. …. increased access to capital could provide the funding essential to develop new products and services and expand an organisation …. While CBH would not be impacted directly, its support for a change in capital raising options [for non-state registered co-operatives and mutuals] stems from a fundamental belief that co-operatives and mutuals are able to contribute in a different capacity – and in some cases a greater capacity – than corporate structures can. The ability to increase the size of this contribution is inarguably linked to their capacity to raise capital."*[123]

119 For example, Bank Australia and Qudos Bank. The joint communique was also attached to several submissions.
120 Page 14.
121 NHC submission to the review, page 1.
122 NRMA submission to the Review, page 3.
123 CBH submission to the Review, pages 1 and 2.

> *"Facilitate a conceptual, regulatory and capital-raising framework recognizing the different objectives and methods of CMEs enabling them to discharge their responsibilities to shareholders/members on an equal footing with for-profit companies in banking and insurance."*[124]

> *"The ability to issue such [a mutual capital instrument] would provide Defence Bank, and other Mutual Banks, a source of capital that can be deployed against new lending thereby allowing Mutual Banks to provide more effective competition to listed banks."*[125]

4.7 External observers and regulators may assert that this risk is overstated, but it is strongly felt by the mutuals sector and several participants in the roundtable meetings commented that their organisation had declined to undertake a range of corporate transactions because of the perceived risk of demutualisation.[126]

4.8 The need for mutuals to have greater access to capital is not unique to Australia. Recommendations 3 and 4 in the UK Ownership Report were:

> *"Britain should reinvent the idea of the mutual, with a new emphasis on preserving the basic principle of mutual ownership. …..*
>
> *New capital instruments are required for mutuals to allow them to raise external capital otherwise their growth prospects are badly damaged. Mutuals should be able to issue bonds to members, count deferred shares as Tier One Capital if trading as a bank or building society or to raise capital for community/public investment and infrastructure projects. Mutual ownership should be incentivised as much as equity ownership. ….."*[127]

4.9 In the United Kingdom, this has already been done by amending specific legislation that governs some mutuals: building societies, friendly societies and mutual insurers.[128]

4.10 In many countries, mutuals do not face the same restrictions on raising capital as in Australia. Examples from the United Kingdom, European Union and Canada were referred to in several submissions to the Review. In the context of mutual financial institutions, see also the comments in paragraph 3.23.

4.11 The Senate Committee believed these overseas developments should be examined:

> *"The committee is of the view the government should consider ways to remove any barriers that impede the sector expanding. The evidence the committee received of developments overseas are initiatives that should be examined for applicability in Australia."*[129]

124 Submission to the Review from Dr Gary Lewis (a cooperatives historian), page 2.
125 Defence Bank submission to the Review, page 2.
126 See also paragraph 3.67.
127 Page 96.
128 For example, the *Mutuals' Deferred Shares Act 2013*.
129 Paragraph 4.48, Senate Report.

MUTUAL CAPITAL INSTRUMENTS

4.12 Most submissions to the Review advocated that the Corporations Act should be amended to permit the issue of a new capital instrument: a "mutual capital instrument" or "MCI" (or a similar term).[130]

4.13 The BCCM / COBA joint communique refers to the instrument being permanent, loss absorbing, investment capital, and having certain minimum characteristics (for example, ranking behind all creditors), but that each mutual would be able to determine other features to suit their business. These were common themes in the submissions to the Review, some of which contained suggestions as to the other features of a new mutual capital instrument. For example:

> *"at the same time, [MCI] will retain features consistent with the mutual purpose of such a business. For example:*
>
> - *MCI will be available only to members of the issuing mutual and qualifying purchasers, as defined in the rules of each mutual.*
> - *Any potential purchaser not currently in membership will be required to qualify for membership of the mutual. Issuing firms will have the flexibility to choose which membership rights are conferred.*
> - *Regardless of the number of MCIs held, each member will be entitled to only one vote.*
> - *No person who is a member only through holding MCI will be permitted to participate in votes on mergers, dissolutions or demutualisation.*
> - *No mutual may issue MCI in excess of 49% of its balance sheet."*[131]
>
> *"The main features of the new instrument would be that it could only be issued as either a permanent or long term instrument not callable by the investor and in its basic form would be entitled to a non-cumulative return out of profits based on a formula. Prima facie as an equity investment, distributions on MCIs would be frankable. The instrument would entitle the holder to one (limited) membership irrespective of the number held. …. The MCI's features are similar to those of the cooperative capital units that are allowed to be issued by cooperatives under NSW legislation, but subjects them to the more appropriate regulation of the prospectus regime of the Corporations Act and allows them to be offered throughout Australia. MCIs would then become part of the national market for financial products."*[132]

130 Most submissions to the Review advocated for an ability to issue a mutual capital instrument by way of amendment to the Corporations Act, rather than through the enactment of separate standalone legislation.

131 BCCM submission to the Review, pages 6-7.

132 Australian Unity submission to the Review, page 5.

"…. key features which protect the integrity of the mutual purpose include:

- *New securities would be permanent*
- *They may confer membership on the holders*
- *They could be owned by individuals or institutions*
- *No member would have more than one vote as a result of holding the shares*
- *Investing members who did not trade with the business would be excluded from any member votes related to mergers or dissolution"*[133]

4.14 However, it is not the case that mutuals are without options:

- Mutuals registered under the Corporations Act as companies limited by shares, or by both shares and guarantee, can issue shares.
- Mutuals registered under the Corporations Act as companies limited by guarantee can convert to companies limited by shares.
- MEIs, if issued by mutually owned ADIs as recommended in Chapter 2, would be a form of mutual capital instrument.

4.15 Some mutuals have taken advantage of these options in the past 20 years. The existing flexibility provided by these options is sometimes used as a reason not to act, but such a view fails to recognise the risk to mutual status in doing so. This risk is significant for mutually owned ADIs and other unlisted TFIs which are subject to the CA demutualisation provisions as discussed in paragraphs 3.50 to 3.76. For other mutuals registered under the Corporations Act, the risk is still perceived as significant.

4.16 These options may also be time consuming and expensive. In addition, the capital instrument issued as a result may not be marketable or not easily understood by investors. The issues of the recognition and understanding of the cooperatives and mutuals sector discussed in previous Chapters also apply to the recognition and understanding of capital instruments issued by mutuals which are not specifically sanctioned in legislation. In the case of mutually owned ADIs, the explicit recognition of MEIs in APRA's prudential standards is important in addressing these issues.

4.17 The barriers to innovation, growth and competition, and the uncertainty as to continuing mutual status, outlined in paragraphs 4.3 to 4.16, would be reduced if the Corporations Act was amended to explicitly recognise a "mutual capital instrument" (or similar term).

4.18 BCCM summarised the proposal in in their publication *Raising New Capital in Mutuals: Removing the barriers to competition and choice*:[134]

- The amendment is a modest addition to the Corporations Act.

133 People's Choice Credit Union submission to the Review, page 2.

134 Page 14.

- It may be used on a voluntary basis by mutual businesses.
- It fixes an anomaly that does not recognise mutuals at law.
- It permits mutuals to issue investment capital without demutualising.
- It mirrors similar legislative amendments in the UK and other countries.

AMENDMENTS TO THE CORPORATIONS ACT

4.19 Paragraphs 4.3 to 4.18, and the earlier paragraphs 3.2 to 3.34, have considered issues which are particularly relevant to Recommendation 17 of the Senate Report - the Government examine proposals to amend the Corporations Act to provide cooperatives and mutuals with a mechanism to enable them access to a broader range of capital raising and investment opportunities. The case for such an examination has been strengthened by the further detail provided in submissions to the Review and roundtable meetings.

REVIEW RECOMMENDATION 8

4.20 The Corporations Act be amended to expressly permit mutuals registered under the Act to issue capital instruments without risking their mutual structure or status.

4.21 It was clear from the roundtable meetings that the cooperatives and mutuals sector was keen to work with Government, and devote the necessary time and resources, to develop consensus on the detail of the amendments and any consequential changes to the Corporations Act.

4.22 Such an amendment to the Corporations Act would necessitate defining “mutual enterprise” (or a similar term) to determine which companies could issue “mutual capital instruments” (or similarly defined securities).

4.23 This would be consistent with Recommendation 4 of the Senate Report - that a “mutual enterprise” be explicitly defined in the Corporations Act, and its associated regulations.

4.24 In addition, defining “mutual enterprise” (or a similar term) would also be a significant step forward in addressing the barriers around inadequate recognition of the mutual form by the general public, investors, regulators, advisers, courts and Commonwealth and State Governments, and reversing the process of “normalisation” and the adverse impact of a lack of legal identity, which have been discussed earlier in the Review.[135]

REVIEW RECOMMENDATION 9

4.25 In committing to amend the Corporations Act to expressly permit mutuals registered under the Act to issue capital instruments, Government also commit to including a definition of mutual company.

135 See paragraphs 1.30 to 1.32 and paragraphs 2.5 to 2.15.

4.26 It is accepted that amending the Corporations Act as recommended raises matters of detail which need careful consideration, and that it is important to properly manage the risk of unintended consequences. However, any further consultation on the detail of the amendments and any consequential changes to the Corporations Act should be a targeted process involving industry associations, regulators and independent experts (for example, the Corporations Committee of the Law Council of Australia).

ISSUES FOR CONSIDERATION IN PREPARING THE RECOMMENDED AMENDMENTS

4.27 A wide range of matters which need to be considered in the amendments to the Corporations Act contemplated by Review recommendations 8 and 9 were raised in the submissions to the Review.

4.28 An important issue to be considered is the extent to which the new capital instrument can only be issued by mutual companies limited by shares, or by both shares and guarantee, to preserve the integrity of the Corporations Act and the essential nature of the distinction between equity and debt, between shares and debentures. In other words:

- should mutual companies limited by guarantee be required to convert to a mutual company limited by shares, or by both shares and guarantee, before issuing the new capital instrument; and

- if the new capital instrument can also be issued by mutual companies limited by guarantee, is it a new category of security (rather than a type of share).

4.29 Allowing mutual companies limited by guarantee to convert to a mutual company limited by both shares and guarantee (or register as a mutual company limited by both shares and guarantee) would involve partially reversing the 1998 changes made to the then Corporations Law by the CLR Act (as well as retaining the existing ability to convert to a mutual company limited by shares introduced by the CLR Act).

The reasons for the 1998 changes should be reviewed as they have had the effect of reducing flexibility, arguably an unintended consequence of the CLR Act.[136] This would be a very modest change since companies limited by both shares and guarantee still exist (that is, they were first registered prior to the 1998 changes), and the Corporations Act already governs such companies.

4.30 The amendments to the Corporations Act contemplated by Review recommendations 8 and 9 would be simpler if the new capital instrument was a type of share rather than a new category of security.

4.31 In addition to considering the position of mutual companies limited by guarantee, and the matters discussed in paragraphs 2.26 to 2.30 in relation to defining “mutual enterprise” (or a similar term), the key matters identified include:

136 The reasons are summarised in footnote 23. Any reversal of the changes should address the aspects of the law perceive to not operate satisfactorily in relation to companies limited by both shares and guarantee (for example, the class rights provisions).

Mutual companies

- a question of terminology: "mutual enterprise", "incorporated mutual company" or "mutual company" or a similar term (see paragraphs 2.19 and 2.20);
- member approvals required for electing to become a mutual company or converting from one type of mutual company to another type;
- should such member approvals extend to approving changes to a mutual company's constitution as part of the election / conversion;
- reviewing the laws for conversion from one company type to another;[137]
- resolving any conflicts with the CA demutualisation provisions and RG147 to ensure the issue of a mutual capital instrument by a TFI does not trigger the CA demutualisation provisions;
- avoiding conflict with the ATO's definition of mutuality for taxation purposes;
- the inclusion of a provision similar to section 11 of the CNL;
- allowing new companies to be registered as a mutual company;
- should the words "Mutual Limited" be required at the end of a mutual company's name; and
- restrictions on the use of the word "mutual".

Mutual capital instruments

- a second question of terminology: "mutual capital instrument", "mutual equity interest" (for consistency with APRA's prudential standards) or "mutual share" or a similar term;
- ensuring MEIs are included within any definition of a mutual capital instrument;
- what characteristics of "ordinary" mutual membership interests should be specified in a definition (for example, nominal value, no dividends, no capital accretion);
- limitations on the distribution of surpluses;
- apart from voting rights (one member, one vote), what other rights of holders of "ordinary" mutual membership interests should be specified in a definition (for example, active use of the goods and services provided by the mutual company, waiting periods and levels of participation);
- should the purchasers of mutual capital instruments be limited to members of the issuing mutual and qualifying purchasers as defined in the issuing mutual's constitution;
- can mutual capital instruments be non-voting or have limited / restricted votes, whilst preserving the one member, one vote principle;

137 Part 2B.7 of the Corporations Act.

- limitations on the quantum of mutual capital instruments a mutual company can issue – this is linked to the key principle in RG147: a company does not have a mutual structure if its dominant purpose is to yield a return to shareholders;

- is a limitation based on total balance sheet value at the time of issue (for example, 49%) an appropriate limitation, or is another test (for example, a test based on the economic relationship test in RG147) more appropriate;

- confirming mutual capital instruments are securities and subject to the CA fundraising provisions;[138]

- reviewing the application of laws relating to takeovers to mutual companies;[139]

- reviewing the application of laws relating to the consolidation and division of shares, reductions of capital; share buybacks, financial assistance and acquisitions of mutual capital instruments by the issuing mutual;[140]

- reviewing the requirements of the Corporations Act, the Corporations Regulations and ASIC Class orders relating to the offer, issue and trading of securities, and Australian financial licenses (and exemptions from the licensing requirements) to ensure that they apply to issues of mutual capital instruments in the same manner as they apply to issues of other securities;[141]

- listing and secondary trading of mutual capital instruments;[142]

- mutual capital instruments should possess the relevant features to qualify for the release of franking credits;

- should holders of mutual capital instruments be able to access franking credits accrued prior to the implementation of the amendments; and

- the withholding tax treatment of payments of dividends or distributions on mutual capital instruments, and the impact of related provisions of the double tax agreements to which Australia is a party.

138 See paragraph 3.79 and footnote 115 in relation to the suggestion that a special purpose disclosure regime for mutually owned ADIs might be appropriate.

139 Chapter 6 of the Corporations Act.

140 Chapters 2H and 2J of the Corporations Act.

141 In his submission to the Review, at page 10, Professor Kevin Davis recommended allowing tradability of mutual capital instruments to provide an element of market discipline via the price movements of such instruments, and that regulators should encourage the ability of issuers to offer secondary markets in such instruments. In the case of prudentially regulated mutuals, APRA does not object in principle to an issuer operating a secondary market designed to bring together willing buyers and sellers, but would likely object to an issuer acting as a market maker and purchasing a mutual capital instrument issued by it on their own account.

142 In his submission, Professor Kevin Davis (page 8) notes the need for some form of secondary market and that this could be operated by the issuing institution. This requires consideration of the market making provisions of the Corporations Act. APRA does not object in principle to a mutually owned ADI operating a secondary market designed to bring together willing buyers and sellers, but would likely object to it acting as a market maker and purchasing capital instruments on their own account.

CHAPTER 5: A MISCELLANY OF OTHER ISSUES

5.1 A broad range of other barriers or issues were raised in the submissions to the Review and in roundtable meetings which are briefly considered in this Chapter.

FURTHER RECOMMENDATIONS IN THE SENATE REPORT

DIRECTORS' DUTIES

5.2 Recommendation 5 of the Senate Report recommended that the role of directors in "mutual enterprises" be defined in the Corporations Regulations to align with the proposed definition of a "mutual enterprise" in the Corporations Act.

5.3 Some submissions were supportive of this Recommendation. For example:

- Australian Unity submitted "that amendments should be made to the Corporations Act to clarify directors' duties as they apply to directors and officers of an [incorporated mutual company]". Australian Unity made a similar submission to the Senate Committee.[143]

- It was noted that a definition of mutuality within the Corporations Act would provide capacity to adapt other elements of the Corporations Act (for example, directors' duties) to the mutual model.[144]

5.4 The concern is that the duties of company directors at common law and the current formulation of those duties in the Corporations Act, do not allow directors of a mutual to take into account the fulfilment of the mutual's purpose and/or the interests of members as recipients of services provided by the mutual.[145] Whilst the issue had not arisen for many of the mutuals which made submissions or participated in the roundtable meetings, when the issue had arisen it was in the context of significant commercial transactions and had resulted in delays and significant cost and, at times, (unnecessary) litigation.

5.5 The Senate Report notes that ASIC considered the current provisions in the Corporations Act would not necessarily exclude consideration of these matters when determining whether a director had acted in the best interests of a mutual,[146] particularly if the mutual's constitution included the stated purpose.[147]

143 Australian Unity submission to the Review, page 4, and paragraphs 3.41 and 3.43 of the Senate Report.

144 COBA submission to the Review, page 23.

145 In this context, it is noted that the formulation of the business judgement rule in section 192(2) of the CNL (similar to section 180(2) of the Corporations Act) allows directors of a cooperative to "[take] into account the co-operative principles where relevant and other relevant matters." ACNC governance standard 5 requires responsible persons of a charity (including directors) "to act honestly and fairly in the best interests of the charity and for its charitable purposes".

146 Paragraph 3.44 of the Senate Report.

147 See also paragraph 2.28.

5.6 The duties of directors remains an important issue before the courts,[148] and a matter of academic and professional interest and discussion in Australia.[149] There is also debate as to the usefulness of the business judgment rule as currently formulated in section 180(2) of the Corporations Act, and the desirability (or otherwise) of the concept of "enlightened member value".[150]

5.7 ASIC commented that the decision of the High Court of Australia in *Mills v Mills*[151] supports the proposition that directors can take a broader interpretation of the interests of member value and may make a decision that may not achieve the maximum financial value. Nevertheless, ASIC indicated to the Review that it accepted that further thought needs to be given to the duties of directors of mutuals.

5.8 At the same time, further thought should be given to other sections of the Corporations Act and Corporations Regulations which impose an obligation to take into account, or otherwise refer to, the interests of members. For example, the oppression remedy in sections 232 and 233 concerning the interests of the members and the requirements for an independent expert's report in a scheme of arrangement.[152]

5.9 Legislative change may not be the only way forward. ASIC could publish guidance; an industry association could obtain advice from leading lawyer(s) and publish a guide for directors of cooperatives and mutuals.[153]

5.10 As noted in paragraphs 2.33 and 2.34, a review of the law in relation to the duties of directors of mutuals is not the primary objective of those cooperatives and mutuals which have advocated for changes to the Corporations Act, but rather a secondary objective. It is also acknowledged that any review of the law in relation to the duties of directors of mutuals is likely to result in calls for a consideration of broader issues beyond those of concern to mutuals; a more holistic review of the directors' duties provisions of the Corporations Act.[154]

148 Most recently in *RBC Investor Services Australia Nominees Pty Limited v Brickworks Limited* [2017] FCA 756.

149 In recent years two justices of the High Court of Australia have delivered The Harold Ford Memorial Lecture at the Melbourne University Law School on the topic of directors' duties. Justice Hayne, "Directors' Duties and a Company's Creditors" in 2014, and Justice Nettle, "The Changing Position and Duties of Company directors" in 2017.

150 See section 172(1) of the UK Companies Act which provides that a director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to (a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company. Section 172 goes on to provide that where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

151 (1938) 60 CLR 15.

152 Corporations Regulations Schedule 8, paragraph 8303.

153 For example, similar to "Duties and Responsibilities of Directors and Officers", now in its 21st Edition, published by the Australian Institute of company Directors.

154 A consideration of broader issues may give rise to delays in considering the matters of concern to the mutuals sector. In their submission to the Senate Committee (pages 9 and 10), Australian Unity noted:

"Australian Unity acknowledges that in the past, suggestions to expand directors' duties in various ways have generally foundered. These debates have focused on considerations of a broadened set of duties in addition to those promoting the economic interests of shareholders and the enterprise as a whole. Such considerations have been held to likely confuse the role of directors, and allow them to have regard to third party stakeholder interests, potentially to the detriment of the interests of shareholders. This proposal is different. In this proposal, though, no third party interests are intended to be added for consideration by directors of mutuals. Rather, it simply clarifies that directors are allowed to recognise the full service interests of their existing set of stakeholders (members / customers)".

REVIEW RECOMMENDATION 10

5.11 Government encourage ASIC to provide regulatory guidance on the duties of directors of mutuals.

5.12 When the directors' duties provisions of the Corporations Act are next reviewed, specific consideration should be given to the adequacy of the law in relation to the duties of directors of mutuals.

ACCOUNTING STANDARDS

5.13 Recommendation 14 of the Senate Report recommended that the Commonwealth Government closely monitor the progress of the International Accounting Standards Board (IASB) in developing solutions to bring cooperative shares under the definition of capital under AASB 132, and, where possible, facilitate equivalent amendments as expeditiously as possible.

5.14 The importance of this Recommendation is stated in the Senate Report:

> *"The committee heard that one of the barriers for a co-operative or a mutual to access capital is how their balance sheets are represented. A member … has voluntarily contributed their shares in the enterprise, and is entitled to a full refund of their contribution should they leave. Current accounting standards therefore treat their shares on the balance sheet as a liability rather than equity."*[155]

5.15 This barrier was highlighted in the submission from Hastings Co-operative Limited:

> *"The treatment of members' shares as liabilities in our balance sheet makes it difficult to raise significant additional funding through this mechanism. Lenders are reluctant to provide additional borrowings if balance sheet ratios and lending covenants are not within acceptable guidelines due to the accounting treatment of our capital."*[156]

5.16 IASB will not be able to finalise their work on a revised standard '*Financial instruments with characteristics of equity*', although the IASB is expected to release a discussion paper in early 2018. In the meantime, the Australian Accounting Standards Board (AASB) are currently working with BCCM on additional guidance to assist cooperatives and mutuals to explain their financial statements.

5.17 The Government should continue to monitor this issue through the AASB.

INNOVATIVE MARKET-BASED APPROACHES

5.18 Recommendation 15 of the Senate Report recommended that Commonwealth and State Governments support the formalisation of some of innovative market-based approaches to raising capital for small and medium sized cooperative and mutual enterprises, in the form of advice and information, as they become available.

155 Paragraph 4.21 of the Senate Report. See also paragraphs 4.22-4.25.

156 Page 2.

5.19 In some submissions to the Review, and in the roundtable meetings, recent initiatives of Government were noted, including, the passing of the *Corporations Amendment (Simple Corporate Bonds and Other Measures) Act 2014* and the *Corporations Amendment (Crowd-sourced Funding) Act 2017*, and the release of the *Social Impact Investing Discussion Paper*[157] in January 2017 in response to a recommendation of the FSI.

5.20 The Government committed in the 2017-18 Budget to continue to work with stakeholders to address regulatory barriers impeding the development and sustainability of the social impact investing market.

5.21 The Government should continue to provide appropriate support to innovative market-based approaches as they become available.

OTHER RECOMMENDATIONS

5.22 The other Recommendations in the Senate Report[158] are not directly relevant to the terms of reference of the Review, although some submissions to the Review commented on those Recommendations, particularly Recommendations 2, 7 and 11.[159]

5.23 Whilst not directly relevant to the Review, to the extent those Recommendations enhance the understanding of the Australian community of the structure and role of cooperatives and mutuals, implementation of the Recommendations is likely to indirectly assist cooperatives and mutuals raise capital by expanding the pool of individuals and investors prepared to provide capital.

DEBT CAPITAL

5.24 The submissions to the Review were almost exclusively focussed on access to equity capital and this is reflected in the discussion in Chapters 3 and 4. However, the Senate Report was concerned with both equity and debt capital.

157 Available on the Treasury website. Chapter 5.4 of the Discussion Paper discusses legal structures for social enterprises and mentions that social enterprises have indicated that they have found it difficult to access the capital necessary to grow their entities, and notes that there is a perception that directors of social enterprise are required to maximise profits over the social mission of the entity.

158 Recommendation 1: National collection of statistics and data.
Recommendation 2: Better representation in government policy discussions and active promotion as an option for service delivery.
Recommendation 3: Encouraging establishment of new cooperatives and "mutual enterprises".
Recommendation 6: Continual improvement to advice, guidance and information on establishment, governance and regulation of cooperatives.
Recommendation 7: Education and training about the role of cooperatives and mutuals.
Recommendation 8: Improve the recognition and understanding of the cooperative and mutual sector in secondary and tertiary education.
Recommendation 9: Professional accreditation bodies require a demonstrated knowledge of the cooperatives and mutual structure before licencing members.
Recommendation 10: Grant funding under the Indigenous Advancement Strategy.
Recommendation 11: Eligibility criteria for government grants and funds.
Recommendation 12: Regulatory Impact Statements.
Recommendation 13: Align regulatory burden to ensure no disadvantage.

159 For example, in relation to Recommendation 11, the Yenda Producers Co-operative submission to the Review.

5.25 In their submission to the Senate Committee, Ernst & Young noted:

> *"The barriers to accessing capital depend on whether it is debt or equity. Typically [cooperative and mutual enterprises (CMEs)], especially smaller co-operatives, rely on debt finance, in the form of debentures or subordinated debt, to raise capital from outside its membership. However, lenders rely on the use of leverage ratios in the credit decision making process. CMEs are at a disadvantage and may not be able to meet the ratio requirements. This is because cooperative member share capital can be treated as a liability rather than equity, a result of share capital being redeemable by these cooperative members when they leave the cooperative.*
>
> *Ratings agencies play a vital role in advising institutional investors on investment decisions; smaller ratings agencies may not have the necessary expertise in cooperative or mutual models to provide advice that leads CMEs to access debt finance."*[160]

5.26 The submissions to the Review reflected the interests of large organisations.[161] As a result, the Review did not consider whether regulatory and legislative barriers currently impede smaller cooperatives and mutuals from accessing capital (particularly debt capital), the significance of those barriers and whether there should be regulatory and/or legislative changes to improve access to capital (particularly debt capital) for smaller enterprises.[162]

STATE AND TERRITORY COOPERATIVES

5.27 Further, as the submissions to the Review reflected the interests of large organisations, the Review did not consider in detail whether regulatory and legislative barriers currently impede State and Territory cooperatives from accessing capital, the significance of those barriers and whether there should be regulatory and/or legislative changes to improve access to capital for State and Territory cooperatives.

5.28 As noted in paragraph 1.59, the regime for the issue of CCUs is immature and untested due to the low volume of issuance to date. However, some submissions did raise the dual regulation of certain offers of securities (other than "member shares" as defined in the Corporations Act).

Cooperatives are required to comply with the disclosure requirements set out in the CNL (or other State legislation) when they offer securities. Disclosure requirements are complicated if an offer is made to persons outside the cooperative's 'home' jurisdiction. The combined operation of s66A and s708(20) of the Corporations Act evinces an intention that interstate offers of securities by a cooperative will be subject to the CA fundraising provisions.

A cooperative undertaking a multi-State and Territory offer of securities is usually required to lodge a disclosure statement with the relevant state Registrar, and an identical disclosure document with ASIC, and pay two sets of fees.

160 Page 20.

161 See paragraph 1.15.

162 For example, the Ernst & Young submission to the Senate Committee noted that in 2011 the Commonwealth Government co-invested in the establishment of three Social Enterprise Development and Investment Funds by providing matched funding (page 21).

5.29 This is barrier to the raising of capital which should be able to be quickly addressed by a change to the CNL (and other State legislation) or by a change to the Corporations Act or the Corporations Regulations.

REVIEW RECOMMENDATION 11

5.30 Government encourage ASIC to review the policy basis for the dual regulation of certain offers of securities by State and Territory cooperatives with a view to implementing legislative changes to eliminate this barrier to the raising of capital by those cooperatives.

PROCESSES WITH REGULATORS

5.31 As noted in paragraphs 3.42 and 3.57, in both submissions and roundtable meetings comments were made as to the (unacceptable) length of time taken by APRA and ASIC in responding to requests by mutuals for regulatory action.

Review recommendations 3 and 4 recommend APRA / ASIC and industry be encouraged to develop minimum service standards (including an agreed process, framework and timetable) and accountability mechanisms for these standards.

5.32 However, these comments are reflective of a broader concern: perceptions held in the cooperative and mutuals sector that:

- regulators do not understand the sector nor the different corporate structure of cooperatives and mutuals – the most commonly held perception;[163]
- regulators are less supportive of entities with cooperative or mutual corporate structures than "normal" companies owned by shareholders;[164]
- regulators have an internal focus rather than an external focus;
- regulators use a one-size fits all approach; and
- decision-making processes are labyrinthine and inconsistent.

Some participants in roundtable meetings commented on, and endorsed some of the, recommendations of the Report to Government *Fit for the future: A capability review of the Australian Securities and Investments Commission* (December 2015).[165]

5.33 In responding to this broader concern, APRA and ASIC both presented different points of view and submitted that the perceptions were largely misplaced.

5.34 Although this broader concern was not considered in detail by the Review, it is clear that the cooperatives and mutuals sector and the regulators disagree. It is to be hoped that Review recommendations 3 and 4 (if adopted by Government) will assist in building strong relationships between the sector and regulators.

163 See also the discussion in paragraphs 1.30 to 1.32.
164 See also the discussion in paragraphs 2.5 to 2.15.
165 Available on the Treasury website.

APPENDIX - LIST OF SUBMISSIONS

Submissions were received from 28 individuals and organisations and, following the roundtable meetings, supplementary submissions were received from five organisations. Non-confidential submissions are listed below.

Apps, Ann
Australian Banker's Association
Australian Mutual Group
Australian Unity
Bank Australia
Business Council of Co-operatives and Mutuals (BCCM)
BCCM Supplementary Submission 1
BCCM Supplementary Submission 2
Chartered Accountants Australia and New Zealand
Co-operative Bulk Handling Limited
Credit Union Australia Limited
Customer Owned Banking Association (COBA)
COBA Supplementary Submission
Defence Bank
Friendly Societies of Australia
Lewis, Gary
Hastings Co-operative Limited
Heritage Bank
hirmaa
Holiday Coast Credit Union
Davis, Kevin
National Health Co-op
NRMA
People's Choice Credit Union
P&N Bank
Qudos Bank
Royal Automobile Club of Queensland
Royal Automobile Club of Victoria
Teachers Mutual Bank