Demutualisation in Australia

Introduction

The ownership structure of Australia's financial sector has undergone substantial change in the 1990s following the privatisation of many government-owned enterprises and the demutualisation of a number of privately owned financial service providers. Privatisations were discussed in a previous article.[1] This article provides information about demutualisations in Australia's financial sector and discusses some of the effects on the financial system. The main conclusions are:

- the net worth, or equity, of demutualised companies (at the time of their demutualisation) amounts to about \$21 billion, controlling assets of about \$180 billion;
- demutualisations have been concentrated among building societies and life offices; and
- demutualisations of life offices, in particular, have directly increased the number of shareholders and boosted share market capitalisation.

A list of demutualisations in Australia since 1985 is provided in Appendix A.

Mutuals

Ownership structure distinguishes mutuals from conventional corporations. While voting rights in most publicly listed companies are determined by shareholdings, with one vote per share, mutuals have one vote per member (or owner) regardless of each member's financial commitment to the company. In mutuals, ownership comes from membership which is based on acquiring a product or service from the company, rather than by contributing capital. Consequently, members typically cannot trade their interests in the mutual.

Many mutually owned financial organisations were originally established as co-operatives, with members pooling resources to achieve a specific objective, such as providing life insurance or low-cost housing finance. Mutuals have since evolved to provide a wider range of financial services, but the broad structure has remained the same. Mutuals distribute profits through bonuses, or reduced premiums and charges. Profits are also often re-invested in the organisation; the accretion of reserves in this way is the main avenue available to mutuals to build capital. Their limited access to other sources of capital can restrict their potential to expand.

1. See 'Privatisation in Australia', Reserve Bank of Australia *Bulletin*, December 1997. An update of the figures contained in this article is provided in Appendix B. Proceeds from sales of public trading enterprises in the 1990s were \$67 billion by November 1998.

In the event of a mutual being wound-up, members may be liable for some nominal amount, but share any surplus assets.

Why demutualise?

The decision to demutualise has been driven by many factors. It may be the need to access external capital to enable expansion, to diversify activities, or to compete more effectively with publicly listed companies in the market concerned. By opening up the organisation to market scrutiny, demutualisation can also assist companies to remove any perception that accountability of management to members is less rigorous than that provided to shareholders in a publicly listed company.

Decisions to demutualise have also been driven by the regulatory framework. For example, prior to July 1998, building societies looking to convert to banks were required to demutualise. Taxation arrangements have also played a part: prior to 1994/95, credit unions were exempt from paying income tax on income derived from loans to non-corporate members. This was a disincentive to demutualise, which was eliminated when the tax exemption was removed. A trend to a more 'level playing field' is expected with the establishment of the Australian Prudential Regulation Authority (APRA), which brings banks, building societies, credit unions, friendly societies, life and general insurance companies, and superannuation funds under one supervisory body, irrespective of their ownership structure.

The process of demutualisation requires the approval of members. The major advantage for current members is that they typically realise the value of the mutual's accumulated surpluses by surrendering their non-tradable interest in return for publicly listed shares. Former members do not share in this distribution of reserves, although the bulk of these reserves might have been generated during the period of their membership. In many cases, the result is a 'windfall gain' to current members, who might also benefit from the taxation treatment of capital gains. In the case of life offices, payments of bonuses on policies are unaffected by demutualisation.

Some mutually owned institutions have decided against demutualising for a variety of reasons. Relatively small institutions, in particular, may place members' benefits – such as lower fees and charges, reduced interest rate spreads and higher bonuses on life policies – above other commercial considerations. Further reasons to retain a mutual status might be to preserve the character of the organisation. This might be a strong motive for organisations with an active membership or one with a regional focus. A mutual structure can also reduce conflicting objectives of customers (seeking to maximise benefits from services of the company) and shareholders (seeking to maximise profits).

International trends

Although hard figures are difficult to find, the trend towards demutualisation is also evident overseas, with a number of life offices, building societies, thrift institutions and stock exchanges either recently demutualised or planning to do so in the near future.

Activity in recent years was concentrated in the UK; in 1997 the demutualisation of five building societies and one insurance company resulted in windfall gains of around £35 billion to members. The demutualisations were via conversions to publicly listed companies, except in the case of one building society which was acquired by a bank. Future activity in the UK is expected to be more limited than in the past as relatively few large mutually owned institutions remain. The other major recent international demutualisation was Switzerland's largest insurer, via conversion to a publicly listed company.

Activity in some other countries has also increased with a number of institutions having demutualised, initiated the process of demutualising or planning to do so. In particular, several insurance companies in Canada, South Africa and the US are converting to publicly listed companies.

A number of large financial institutions retain their mutual status in continental Europe, including Germany, where mutuals make up about a fifth of the banking business (measured by assets) and two-thirds of the number of institutions. Mutuals are also common in the Netherlands, France and Italy. Members of these mutuals seem reluctant to demutualise because co-operative banks, for example, have close links to their communities. There are signs, however, of greater interest in demutualising in these countries, partly to avoid mutuals becoming targets for takeovers.

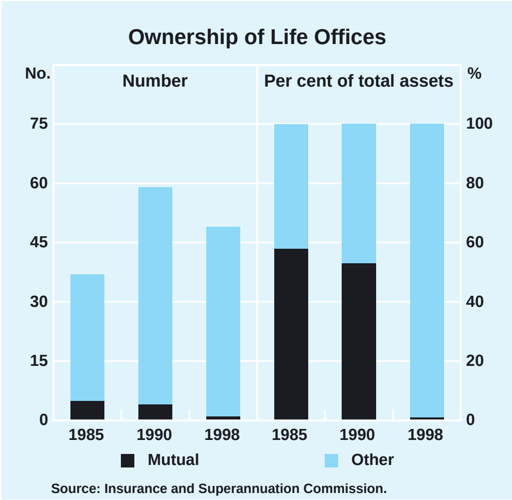
Demutualisations in Australia

There has been a fairly steady stream of demutualisations in Australia since the mid 1980s, with successive peaks being reached in recent years largely because of demutualisation of major life offices (see Table 1). Demutualisations have also been common among building societies. To date only one credit union has demutualised and no friendly society has done so. The Australian Stock Exchange demutualised in October 1998.

Life offices

Although mutually owned life offices in Australia have been few in number, they have accounted for a large share of total industry assets (Graph 1). In 1985, of the 37 life offices, five were mutually owned. Since the demutualisations of Capita (October 1990), National Mutual (September 1995), Colonial (December 1996) and AMP (January 1998), only one life office now remains mutually owned. Industry assets held by mutuals have fallen from 58 per cent in 1985 to under 1 per cent in 1998.

Graph 1



The three most recent demutualisations were initiated by management and took the form of an issue of ordinary shares to members in exchange for membership rights. The demutualisations were each followed by a public share offer and listing on the Australian Stock Exchange. The prime reason for demutualisation was, in each case, to improve the institutions' access to capital markets.

Table 1: Value of Demutualisations in Australia's Financial Sector

	Total assets ($ million)	Net assets ($ million)
1985	2 100	100
1986	300	10
1987	7 400	270
1988	1 100	10
1989	3 700	270
1990	3 600	200
1991	–	–
1992	400	10
1993	900	30
1994	1 900	90
1995	27 800	3 360
1996	38 400	1 710
1997	100	10
1998	95 500	15 230

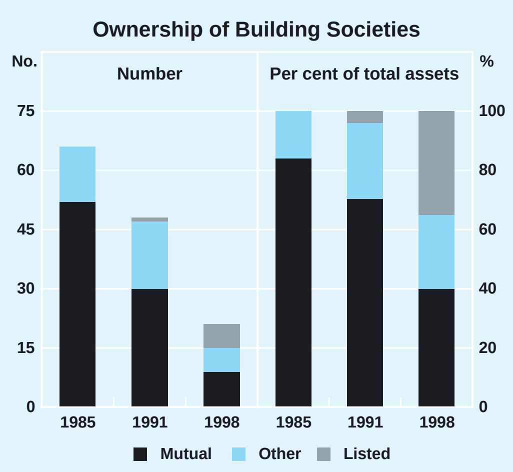
Building societies

Most building societies were initially established as mutually owned co-operatives. In 1985, there were 66 building societies, of which 52 were mutually owned or controlled, representing 84 per cent of industry assets (Graph 2). Consolidation and demutualisation have resulted in the number of building societies contracting to 21 in 1998, of which nine remain mutually owned or controlled (40 per cent of industry assets). Over the same period, the share of total assets of deposit-taking institutions held by building societies fell from 9 per cent to 2 per cent. Thus the proportion of assets of deposit-takers held in mutually owned building societies is currently less than one per cent, compared with 7 1/2 per cent in the mid 1980s.

As noted, until recently, building societies seeking to convert to bank status were required to demutualise. Of the thirteen building societies which have become banks, nine had been mutually owned. On APRA's formation in July 1998, regulations were introduced to permit building societies to retain a mutual structure when converting to a bank.

Another nine building societies have demutualised by converting members' interests into 'permanent share capital' which is traded on the Australian Stock Exchange or an exempt exchange. This listed capital typically attracts one vote per shareholder, regardless of the size of individual shareholdings, allowing these institutions to retain a key feature of mutually owned companies. In November 1997, The Rock Building Society became the first building society to convert its mutual-type voting rights to one vote per share.

Graph 2



Source: Financial Corporations Act data.

In 1994, in response to the growing number of building society demutualisations and to ensure a fair distribution of any accumulated surpluses, the Australian Financial Institutions Commission (AFIC) introduced standards to govern the demutualisation of building societies.

Credit unions and friendly societies

AFIC also introduced, in 1997, standards to govern the demutualisation of credit unions and friendly societies. While the standard governing the demutualisation of friendly societies is similar to that for building societies, legislation governing credit unions does not permit demutualisation via the issue of permanent share capital. Consequently, if credit unions wish to demutualise, they are required to convert to another form of institution or be acquired by another institution.

To date, no friendly society has demutualised and only one credit union has done so through acquisition by a building society, with members of the credit union offered shares in the building society at a highly discounted price.

Australian Stock Exchange

The Australian Stock Exchange demutualised in October 1998, generating gains of around $440 million for its members. The main purposes of demutualising the Stock Exchange was to broaden its membership base to all users of its services, and to enable the Exchange to compete more effectively with other providers of like financial services.

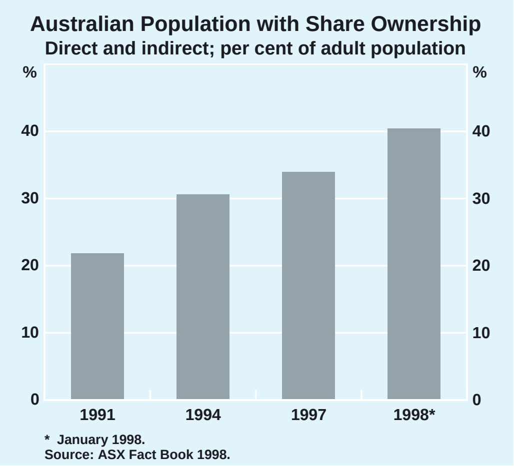
The Commonwealth Government has imposed an ownership limit of 5 per cent for individual shareholders to prevent any party exercising undue influence on the affairs of the Exchange. Since the Stock Exchange is now listed on its own market, the Australian Securities and Investment Commission (ASIC) supervises the Exchange's compliance with its own listing rules. Five overseas stock exchanges have listed in recent years but none on its own exchange.

Financial market effects of demutualisation

The supply of securities in the equity market has increased sharply as a result of demutualisations and privatisations via public floats.[2] A rising share market and strong demand from the growing managed funds industry has helped investors absorb these new share issues. This process has also been associated with a large number of new investors in the market.

While some members elected to take immediate advantage of these windfall gains by receiving cash in lieu of their shares prior to the life office listing, the majority chose to retain their shareholding at the time of listing. Just under half of National Mutual's eligible policyholders elected to retain their share allocation, compared with 77 per cent and 88 per cent for Colonial and AMP, respectively.

Graph 3



In early 1998, the proportion of adults in Australia with direct or indirect ownership of shares was 40 per cent, double its level in 1991 (Graph 3). In AMP's share market listing

Table 2: Number of Shareholders and Market Capitalisation of Selected Australian Companies

	Shareholders ('000)		Capitalisation(a) ($ million)	Rank according to capitalisation
	Initial listing	Latest available		
Telstra(b)	1 900	1 400	32 700	3
AMP(c)	1 400	1 200	23 000	5
TAB Limited(d)	840	570	1 600	59
National Mutual(c)	540	470	5 300	19
Colonial(c)	530	420	5 100	20
Commonwealth Bank(d)	480(e)	420	21 500	6
BHP	..	310	23 500	4
Coles Myer	..	300	9 400	12
Woolworths	..	260	6 400	15
National Australia Bank	..	250	36 100	2
memo item:				
News Corp	..	50	37 200	1

(a) At mid-December 1998.
(b) Partly privatised.
(c) Demutualised.
(d) Fully privatised.
(e) Following payment of the final instalment receipt.
Source: Australian Stock Exchange, annual reports and corporate share registries.

2. See 'Privatisation in Australia', Reserve Bank of Australia *Bulletin*, December 1997 for a discussion of the financial market effects of privatising the former public trading enterprises.

last June, 10 per cent of the adult population received shares. As a significant proportion of the recipients of shares in AMP were likely to be shareholders for the first time, the proportion of the population holding shares may have risen further. An offsetting factor, however, is that the number of shareholders in demutualised and privatised companies tends to decline after the initial listing, as individuals realise their capital gains by selling their holdings. These holdings are often acquired by institutions seeking to duplicate standard market investment indices.

Even so, the six companies with the largest number of shareholders in Australia are all ones which have recently privatised or demutualised, as shown in Table 2 (listed according to the size of their share registers).

Privatisations and demutualisations have boosted market capitalisation and the liquidity of the share market. The three listed demutualised life offices and listed banks (that were formerly building societies) account for around 8 per cent of total domestic market capitalisation, and about the same proportion of turnover. Privatised institutions account for 12 per cent of the market and about 10 per cent of turnover. The figures on turnover of demutualised companies might be overstated by the recent listing of AMP; as the market in these shares settles, turnover in them might also decline from its recent high level.

Demutualisations can also have potentially important macroeconomic effects. Whereas privatisations require payment in exchange for shares, demutualisations have created substantial ‘windfall gains’ for members, particularly in the case of the life offices. A proportion of these windfall gains is likely to be spent. The Bank estimated prior to the share market listing of AMP that it might in the near term add a few tenths of one per cent to annual GDP, based on an expected market capitalisation of $13½–$17½ billion.[3] In the event, market capitalisation of AMP has been over $22 billion, suggesting the possibility of larger effects on household spending than were previously estimated.

3. See ‘Box B: Telstra Float and AMP Demutualisation’, *Semi-Annual Statement on Monetary Policy*, May 1998.

Appendix A: Demutualisations in Australia since 1985

	Institution formed as a result of demutualisation	Date of demutualisation	Selected balance sheet data[a] ($ million) Total assets	Net assets
Life Offices[b]				
Demutualisation via acquisition by another life office				
Capita Financial Group	MLC Life	Oct 90	2 979	148
Demutualisation via part share issue to former members and part sale to foreign interests				
National Mutual Life	National Mutual Holdings	Sep 95	27 767	3 355
Demutualisation via share issue to former members				
Colonial Mutual Life Assurance Society	Colonial	Dec 96	38 425	1 705
Australian Mutual Provident Society	AMP	Jan 98	95 246 [c]	15 059 [c]
Total Life Offices			**164 417**	**20 267**
Building Societies and Credit Unions				
Demutualisation via conversion to a bank				
NSW BS	Advance Bank Australia	Jun 85	2 123	103
Civic Co-operative PBS	Civic Advance Bank	Jun 86	346 [d]	13 [d]
United PBS	National Mutual Royal Savings Bank (NSW)	Mar 87	1 667	55
Perth BS & Hotham PBS	Challenge Bank	Apr 87	1 851	69
Tasmanian PBS	Tasmania Bank	Sep 87	211	8
Metropolitan PBS	Metway Bank	Jul 88	1 103 [e]	11 [e]
RESI-Statewide BS	Bank of Melbourne	Jul 89	3 015	228
Canberra Permanent Co-operative BS	Canberra Advance Bank	Aug 90	651 [f]	52 [f]
The Co-operative BS of SA	Adelaide Bank	Jan 94	1 863	92
Demutualisation via listing on the Australian Stock Exchange				
The Rock BS	..	Dec 92	162	5
Northern BS	..	Jul 93	391	11
Ipswich & West Moreton BS	..	Oct 93	220	8

Appendix A: Demutualisations in Australia since 1985 (*continued*)

	Institution formed as a result of demutualisation	Date of demutualisation	Selected balance sheet data[a] ($ million)	
			Total assets	Net assets
Demutualisation via listing on an exempt exchange				
St George BS	..	May 87	3 706	138
Illawarra Mutual BS	..	Aug 89	698	38
Wide Bay Capricorn BS	..	Dec 92	219	6
Mackay PBS	..	May 93	96	3
Pioneer PBS	..	Aug 93	90	1
First Provincial BS	..	Nov 93	124	5
Demutualisation via acquisition by building society				
Sunstate Credit Union	First Provincial BS	Oct 97	103	8
Total Building Societies and Credit Unions			**18 639**	**854**
Stock Exchange				
Demutualisation via share issue to members				
Australian Stock Exchange	..	Oct 98	234	175
Total All Demutualisations			**183 290**	**21 296**

(a) Data are as at the balance date immediately prior to demutualisation, except for life offices which are as at the time of demutualisation. Net assets are total assets less total liabilities, that is owners' equity.

(b) Includes funds under management.

(c) Pro-forma balance sheet data.

(d) As at May 1985.

(e) As at June 1987.

(f) As at June 1989.

Notes: PBS, Permanent Building Society; BS, Building Society.

Sources: Australian Financial Institutions Commission, various annual reports and other sources.

Appendix B: Update on Privatisations in Australia[(a)]

	Proceeds ($ million)	Type of sale	Month
Commonwealth Government			
Airports (Phase 2):			
Adelaide and Parafield	362	trade	May 98
Archerfield	3	trade	Jun 98
Canberra	66	trade	May 98
Coolangatta	105	trade	May 98
Darwin, Alice Springs and Tennant Creek	110	trade	Jun 98
Hobart	36	trade	Jun 98
Jandakot	7	trade	Jun 98
Launceston	17	trade	May 98
Moorabbin	8	trade	Jun 98
Mt Isa and Townsville	16	trade	Jun 98
Auscript	1	employee buyout	Jun 98
Australian Multimedia Enterprises Ltd	29	trade	Apr 98
Department of Administrative Services Business Units:			
Asset Services	19	trade	Sep 97
Australian Operational Support Services	2	trade	Aug 97
Australian Property Group	3	trade	Oct 97
DAS Centre for Environmental Management	0.01	employee buyout	Oct 97
DAS Distribution	1	employee buyout/trade[(b)]	Sep 97
Interiors Australia	0.1	employee buyout	Sep 97
WORKS Australia	4	trade	Aug 97
Housing Loans Insurance Corporation	108	trade	Dec 97
Total Commonwealth	**897**		
State Governments			
New South Wales			
NSW Totalizator Agency Board	937	public float	Jun 98
Victoria			
Electricity Industry:			
Hume	8	trade	Sep 98
Victorian Electricity Metering	8	trade	Dec 97
Victorian Network Switching Centre	8	trade	Nov 98
Other:			
Aluvic	502	trade	Aug 98
Victorian Plantations Corporation	550	trade	Nov 98
Queensland			
Suncorp-Metway Ltd[(c)]	1 011	public float	Nov 98

Appendix B: Update on Privatisations in Australia[(a)] *(continued)*

	Proceeds ($ million)	Type of sale	Month
Western Australia			
Dampier-Bunbury Natural Gas Pipeline	2 303	trade	Mar 98
Total State Governments	**5 327**		
Total All Governments	**6 224**		
Memo items:			
Total trade sales/employee buyouts	*4 276*		
Total public floats	*1 948*		

(a) This table updates figures contained in 'Privatisation in Australia', Reserve Bank of Australia *Bulletin*, December 1997, to include privatisations since that article was prepared and a small number of privatisations which had occurred in 1997 but details of which were not publicly available at the time of writing.

(b) DAS Distribution was sold to a joint venture between an employee buyout team and Ausdoc Group Ltd.

(c) The Queensland Government sold the remainder of its shareholding in Suncorp-Metway Ltd. The first instalment of $570 million was received in November 1998. The second instalment of $441 million is due November 2000.