LAST DAYS OF THE CREDIT UNION?

In a recent article (JASSA March 1995) Michael Waterhouse outlined some of the inconsistencies in the current approach to supervision of non-bank financial institutions. In this article KEVIN DAVIS describes two additional inconsistencies arising from government policies which threaten the future viability of cooperative financial institutions such as credit unions.

Few participants in financial markets would argue with the premise that, in the absence of good reasons to the contrary, government regulation and taxation should try to avoid creating a non-level playing field. Unfortunately, well-intentioned policies implemented over the past year or so have had such an effect and will adversely affect the competitive position of credit unions.

Two major regulatory changes have occurred. First, credit unions are subject to capital adequacy requirements, introduced by the Australian Financial Institutions Commission (AFIC) to protect depositors. Second, credit unions are now subject to company tax, from which they were previously exempt.

To some observers, these developments might appear fair and reasonable because other financial institutions are subject to the same requirements. Such a view is incorrect, because it ignores the fact that credit unions are cooperative institutions and inherently different from other financial institutions.

The adverse effects on credit unions stem from the fact that the owners of credit unions are, in fact, their depositor and borrower members, and that credit unions can (subject to some minor qualifications) only acquire capital reserves by making and retaining profits from their dealings with members.

Unlike other financial institutions which can raise capital externally, credit unions are constrained to internal generation of capital. Unlike other financial institutions where owners can realise cash for their "share" of an institution's net worth by selling their shares, credit unions do not have transferable shares. Members who leave the credit union do not realise anything from the capital which has been accumulated in the organisation as a result of their dealings with the credit union. Future members benefit from the deposit protection afforded by the larger capital base of the credit union, at the expense of current members from whom profits are generated.

Hence the first anomaly. AFIC requires credit unions to increase their capital reserves by making an "adequate" level of profits (surplus). But at the same time, the government, by taxing profits, effectively reduces the ability of credit unions to accumulate capital. To achieve higher capital ratios, the credit union will need to make higher profits from its dealings with current members. Future members (and supervisors) will benefit from any increased capital base but current members will have less incentive to deal with the credit union because of its need to make higher profits.

The second anomaly arises from the effect of the dividend imputation system.

Under dividend imputation company tax "washes out" for companies which can pay franked dividends and have shareholders who can use franking credits. Profits which are taxed at company level and then distributed as franked dividends carry tax credits for shareholders. Credit unions, because of their cooperative status, have no mechanism for paying franked dividends. Not only do the profits they accumulate at the expense of current members sink into the bowels of the organisation, so do the franking credits arising from company tax.

This has several adverse consequences and inequities. First, credit unions (if they survive) will build up significant franking account balances. This will increase the incentive for entrepreneurs (using the word in the pejorative sense) to find ways to gain control of credit unions and convert them to a form where the accumulat-
ed wealth and tax credits can be gutted at the expense of members.

Second, to the extent that credit union members are from lower income groups with personal tax rates below the company tax of 33%, the application of company tax is discriminatory. Were they shareholders in a bank, the distribution of franked dividends would mean that their share of income would be taxed in total (after allowing for tax credits) only at their lower personal tax rate.

The impact of these regulatory forces is that credit unions as we know them today are unlikely to survive. There are at least three possible outcomes. First, those credit unions with natural advantages which enable them to remain competitive will be characterised by an increasing stock of accumulated reserves and undistributed franking credits. This will certainly induce opportunistic behaviour by some individuals aimed at unlocking that communal wealth for their own private gain, by gaining control and changing the structure of the organisation. Second, some credit unions will find that the ability to compete will diminish and will gradually disappear from the finance sector. Third, credit unions will seek some alternative ownership structure which enables members to gain entitlements to accumulated profits and franking credits generated by the institution's operations.

It may be that the latter course of action – mutation to a different form – is the most appropriate. Cooperative financial institutions may be unsuited to the modern financial world, although that is far from proven. What is of concern, however, is that such developments are likely to occur as a by-product of unsuited tax and regulatory policies, rather than as a result of a conscious recognition of the need for institutional change.

A QUESTION OF CONTEXT

In the March 1995 issue of JASSA we presented the results of an evaluation survey in an article titled Spade Work – How Miners Value Resources. In a follow-up article (JASSA June 1995), Graeme Robson assumes that the article states that discounted cashflow analyses carried out in real and nominal terms are irreconcilable.

This is clearly untrue and is well demonstrated by Robson's review of basic cashflow analysis and Fisher's Theorem of Interest Rates. This includes discounting both depreciation and return of working capital in real modelling – a process which is generally not carried out by smaller companies in the mining industry.

DEPRECIATION

Depreciation in the model is calculated on a straightline basis from the initial capital investment. In modelling in real terms, operating costs and revenues are assumed to be inflating at the same rate. However, the depreciation does not inflate as it is set with the initial capital investment.

Therefore, in real terms, an incorrectly inflated yearly depreciation charge will occur unless it is discounted by an assumed inflation rate – an assumption which many companies avoid by calculating in real terms, not discounting the depreciation charge and accepting the error.

A similar issue occurs with the return of working capital at the end of a project. The return of working capital should theoretically be discounted by the assumed inflation rate. Note Robson has not included the return of working capital in his reworked example.

The article Spade Work – How Miners Value Resources discusses the mining industry applications of discounted cashflow modelling. Smaller companies in the industry do not correctly model in real terms but accept and acknowledge the error produced. This is commensurate with the objectives of the modelling exercise, also given that there are inaccuracies elsewhere in the model – for example, operating cost estimates or commodity price forecasts.

Our article is not stating that nominal and real cashflows cannot be reconciled. It points out the inaccuracies produced by companies using these techniques, clearly stated in the example: "Real modelling without deflating depreciation allowance or return of working capital at the end of project life."

In the mining industry, larger companies model in nominal terms and convert to real terms. As mentioned, smaller companies generally model in real terms but do not correct depreciation, working capital, some royalties, etc. in the model and accept the inaccuracy produced.

Our article correctly states that at an inflation rate of 6 per cent the IRR error is around 1 per cent and decreases with the inflation rate. While Robson has taken the example out of context, the discussion nevertheless serves to highlight the issue of technical correctness versus the practicalities and objectives within the mining industry.

– Stephen Bartrop and Andrew White