Capital Raising at Co-operative Banks

Ethical Consumer Research Association

for the

Customer Union for Ethical Banking

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1 The Problem of Capital

Although mutual and co-operative banks faired relatively well during the 2008-09 financial crisis, the subsequent financial regulations adopted to mitigate the likelihood of another banking crisis have had damaging ramifications for these banks through-out the world (Mayo, 2015). To insulate from another crash, 'Tier 1' capital[1] requirements of all banks have been increased, and regulation of the banking sector is now far more rigorous. The Basel III Accords[2] sets out a minimum requirement that all banks must maintain at least 6% Tier 1 capital ratio, of which 4.5% must be Common Equity Tier 1 (CET1)[3]. The Bank of England have expressed a desire that all UK banks maintain an 11% risk-weighted asset (RWA)[4] ratio to further buffer against turbulent financial markets, although they have the same minimum of 6% (Bank of England, 2015).

The UK's Co-operative Bank announced in January 2017 that it expected that its CET1 ratio would fall and remain below 10% over the medium term and, as a result, was unlikely to meet its Individual Capital Guidance over the planning period to 2020 (Co-operative Bank, 2017a). The next month it announced that it would embark on a process to sell the bank, as well as looking at other ways of building its capital position (Co-operative Bank, 2017b). An analysis of the Co-operative Bank's financial records shows that it had been maintaining a more than satisfactory CET1 ratio until this point (See Section 5 below). The challenge that financial mutuals and co-operatives face is that it is difficult for them to directly issue equity (shares) to outside investors because they are owned by their members (typically depositors and savers), and issuing equity would dilute their cooperative ownership. This paper looks at the ways that other co-operative banks throughout the world have tried to acquire capital to meet regulatory requirements, while seeking to maintain democratic control, as well as the extent to which these methods could be applicable to the UK's Co-operative Bank.

1 'Tier 1' capital is core capital, which comprises of equity capital (stocks and shares) and disclosed revenues (retained earnings). For a more detailed but concise explanation of capital please see Kuijpers and Groeneveld (2016, p. 50-52).
2 Basel III Accords are an internationally accepted set of voluntary regulations designed to mitigate the likelihood of a repeat of the 2008-09 financial crisis.
3 A component of 'Tier 1' capital that consists mostly of common stock held by a bank or other financial institution.
4 Bank of England. (2015) The framework of capital requirements for UK banks. *Bank of England.*

It is important to highlight that the Co-operative Bank is not a co-operative, but a Public Limited Company (see section 3.3). It was previously a co-operative by association, as it was 100% owned by the Co-op Group. As we see below, that stake was reduced to 30% in 2013 and 20% in 2014.

2 Democratic Control

The subject of member control is the pivotal consideration of '*Five ways co-operatives can access more capital – whilst staying true to the principles'* (Andrews, 2015). Andrews suggests multiple capital raising techniques which reserve all, or a majority of, voting rights for co-op members and thus retain democratic control.

> *"Is the membership able and willing to make additional investment in the co-operative? If so, then the debt or equity instruments must be structured to be attractive to members while still preserving democratic control. Debt instruments and multiple share classes can preserve the one-member, one-vote structure while attracting investments of different amounts by individual members."* (Andrews, 2015)

Later, this report will look at three other co-operative banks - Rabobank (Netherlands), Desjardins (Canada) and Norinchukin (Japan) - which turned to their membership to raise capital whilst retaining democratic control for members.

Threatened with collapse in 2013, the Co-operative Bank turned to its bondholders to plug the £1.5 billion capital shortfall, and the Co-operative Group agreed to reduce its stake in the Bank to 30% and to list the Bank on the stock exchange (Mayo, 2015; Treanor, 2013). And in 2014 a further £400 million shortfall forced the Co-operative Group to reduce its stake to 20%[5] (Butler & Treanor, 2016). Although the Co-operative Group - a member-owned and controlled co-operative - is still a significant shareholder in the Bank, it has sacrificed a significant amount of control over the bank to help secure its future.

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5 This loss was attributed to lower than expected interest rates and higher than expected compensation payments for mis-sold PPI (Treanor, 2014).

Andrews (2015) recognised the potential problems of this type of solution saying:

> *"If non-member investment is to be sought, there must be a balance between making the instrument an attractive investment and preserving member control. Debt instruments, multiple classes of shares, and tiered or holding company structures all offer ways that this can be achieved. But it is important to note that even though de jure member control may be maintained, outside investors may exercise significant de facto influence over the co-operative."*

3 Alternative Ways of Raising 'Tier 1' Capital

Ed Mayo (2015) highlights that, historically, mutuals have raised capital by issuing hybrid debt-equity capital instruments[6] which were classed as 'Tier 2' capital[7]. However, the increased 'Tier 1' capital requirements for banks have put co-operative banks under significant pressure. This leads us to ask, are there types of investment which are compatible with co-operative values that qualify as 'Tier 1' capital? The cases listed below show three co-operative banks around the world which have enhanced their capital position through member-only capital instruments, the challenge of which is maintaining the one member one vote co-operative model.

3.1 Member Investment

3.1.1 Rabobank – Netherlands

Kuijpers and Groeneveld (2016) analyse the case of Rabobank's 'member certificates', first issued in 2000, as a method of internal capital raising.

> *"This financial title is basically a subordinated bond[8] without voting rights and with an undefined maturity and a yield dependent on the realization of sufficient profits*

6 Hybrid capital securities, or securities that have some equity characteristics and some debt characteristics. For more information please see Eiger *et al.* (2015).

7 'Tier' 2 capital is considered more risky than 'Tier 1' but is still designated as supplementary capital. See Kuijpers and Groeneveld (2016, p. 50-52) for more information.

8 Subordinated debt is considered any type of loan that's paid after all other corporate debts and loans are repaid, in the case of borrower default. Borrowers of subordinated debt are usually larger corporations or other business entities.

> *for capital formation. Such a capital instrument qualifies as CET1 under European regulation."*

In light of the bank's 'AAA' credit rating, demand for these certificates was high and the bank sold around 150,000 to its members; these certificates were not publicly listed but traded on an internal market maintained by Rabobank. "The total amount of outstanding member certificates increased steadily to almost EUR 6 billion" in 2015 (Kuijpers & Groeneveld, 2015). Andrews (2015) adds that these certificates are "subject to writedown if Rabobank's Tier 1 ratio sinks, or may sink, below 8%", meaning that Rabobank has the "ability to absorb losses on a going concern basis through conversion to common equity or writedown".

In December 2013, Rabobank expressed its intention to make these certificates available to external investors. This was motivated by an increased supply of 'member certificates' in Rabobank's internal market, owing in part to Dutch regulators who required Rabobank to make certificate holders aware that this scheme was not a risk-free savings product but an investment product (Kuijpers & Groeneveld, 2015). Since January 2014, these certificates have been listed on the Euronext Amsterdam market and are still deemed 'Tier 1' capital without voting rights. Rabobank's (2017) website states that: "Currently, a number of 297,961,365 Rabobank Certificates are outstanding with a nominal value of EUR 25,00 each", totalling over €7.4 billion. This move by Rabobank relates to the arguments put forward by Andrews (2015), on the potential impact that opening up capital instruments such as these to outside investors can have on a co-operatives democratic structure. This gives investors the option of putting money into the bank without having *de facto* democratic voting rights.

3.1.2 Desjardins – Canada

Another successful example of a co-operative turning to its members for capital through issuing new shares has been Canadian co-operative bank Desjardins (Biddy, 2014). The bank, which is the largest association of credit unions in North America, reported in 2015 that 'Federation capital shares' bought by their own members since 2012 were worth CAD2.5 billion (Desjardins, 2015). By designing these capital instruments to meet the 'Tier 1' capital criteria set out in Basel III, the bank strengthened its capital position significantly and is considered to be one of the safest banks in North America (Biddy, 2014). Not only can these shares exclusively be purchased by Desjardin members, but (akin to Rabobank's initial certificates model) can only be traded internally; moreover, they are without voting rights (Desjardins, 2016, p. 12). Back in 2014 the bank's vice president said that, "about 60,000 individual members have so far bought shares. We plan to increase the number to 300,000 members in the next five years" (Biddy, 2014).

3.1.3 Norinchukin – Japan

During the financial crisis of 2008-09, Norinchukin Bank, a Japanese co-operative bank serving large Japanese corporations in the fishing, forestry and agricultural sectors, lost 20% of its 'Tier 1' capital because of exposure to US mortgage securities (The Norinchukin Bank, 2009). The bank sought to recapitalise through member investment by issuing lower dividend rate stocks and permanently subordinated loans to its co-operative members (The Norinchukin Bank, 2009). These stocks were classed as common equity and as such qualified as 'Tier 1' capital (IMF, 2012). From 2007 to 2009 the bank issued ¥1941.8 billion (£14.13 billion) of these capital instruments (The Norinchukin Bank, 2012), in doing so the Bank stemmed the flow of outgoing 'Tier 1' capital and increased its 'Tier 1' capital percentage to over 20.2%. It is however unclear whether this impacted the bank's democratic control of membership or individual member voting rights.

3.1.4 Comparative Analysis

Seeking capital from co-op members has been shown to be a potentially effective option for co-operative banks. Conditionalities attached to 'Tier 1' capital instruments by co-operatives can attempt to retain democratic control for members whilst growing capital reserves. The financial position of a co-operative bank when it issues capital instruments such as these appears crucial to their success. Rabobank and Desjardins both held strong credit ratings and, as such, their schemes were successful. Norinchukin differs from this since, although it was financially weakened when calling for capital, it was a bank for large businesses and so could draw on its member's significant capital resources.

If investment instruments are created which are non-voting and only sold to existing co-op members, this seems to be a way of increasing 'Tier 1' capital without compromising control. However, the Co-operative Bank currently has no members, so this option is not available. Selling similar non-voting shares to customers of the Bank, which could be collectively held by a democratic body, might be a way of addressing this issue.

3.2 Co-operative Fund Investment

The International Cooperative Alliance (2013) calls for: "Accelerating global trade between co-operatives through broker arrangements and shared service structures". Jean-Louis Bancel (2016) says that international investigation should take place on:

> *"Inter-cooperation between co-operatives, either by creating shared tools that deliver capital savings (shared resources), mutual contributions of financial means, or common tools for financial capacity building."*

Mayo (2015) writes:

> *"For cultural, governance or other reasons, the UK building-society sector has not been effective at secondary co-operation… when compared to German co-operative banks, which audit each other and share capital, or the highly successful, federated model of Desjardins, bringing together 376 credit unions serving 5.8 million members in Canada."*

And:

> *"[I]t may well be that there are options too for pooling capital, to meet rising regulatory requirements, with wider co-operatives and mutuals worldwide."*

Practically, Andrews (2015) proposes that:

> *"One potential option to lever the co-operative investment is establishing a fund that could be structured as a private equity fund, mutual fund, unit trust, or exchange-traded fund. Such a fund could invest in the debt and/or equity of co-operatives, providing investors with the ability to acquire a diversified co-operative portfolio investment by purchasing units in the fund."*

Apparently, there is one co-operative bank operating in the European Economic Area which is pursuing a similar idea by using Luxembourg based SICAV structures (investment societies with variable capital) as a means of investing in other financial co-operatives on a global basis. Their shares in the SICAV count as Tier 1 capital.[9]

These approaches lend themselves to the idea of a more internationalised and integrated approach to co-operative capital; looking beyond the localism which is at the heart of the co-operative movement. The weakened current position of the Co-operative Bank however means that it is unlikely to be a prudent investment for other co-operative institutions in its current form.

3.3 Publicly traded company model

Some mutuals have voluntarily opened themselves up to shareholder capital in the same way that the Co-operative Bank has done. Typically this has been done by creating a publicly listed company which the members partly own but which also has private investors (Biddy, 2014). For example, the largest mutual banking group in the world, Credit Agricole Group, is partly listed on the stock market, and institutional and individual investors own 40% of the parent bank's shares (Biddy, 2014). The obvious problem with this model is the risk of losing the very essence of a co-operative bank, because there is a need to ensure that external investors don't use their *de facto* sway to threaten co-operative values.

4 Remutualisation

Another way the Co-operative Bank could seek to increase democratic control, which may also impact its capital position, is through 're-mutualisation'. Following the 1986 Building Societies Act, UK building societies were permitted to offer current accounts and SME (Small and Medium Enterprises) loans, and to demutualise if sufficient member support was gained (Mayo, 2015). Most of the UK's largest building societies, with the exception of Nationwide and Britannia, demutualised and became shareholder-owned 'mortgage banks' (Mayo, 2015).

9 Email from Professor Tony O'Rourke May 19th 2017

In 2005, savings business Bristol & West was purchased by the then second largest UK mutual, Britannia (Britannia, 2005). This merger was the first re-mutualisation of a former building-society. Ironically, it was the acquisition of Britannia's problem assets which lies at the root to the Co-operative Bank's current problems.

However, re-mutualisation was also considered in the case of Northern Rock in 2010. “The case for remutualising Northern Rock can be made on the basis of the intrinsic merits of the mutual model, the systemic advantage of having a mixed system with a critical mass of mutuals along with other bank models” (The Building Societies Association, 2009). This proposal became a manifesto promise of all the Labour leadership candidates during the 2010 election campaign (Appleby, 2010). However, Labour’s election defeat in 2010 led to Northern Rock being put up for sale and subsequently bought by Virgin Money in November 2011 (BBC, 2011).

It is worth mentioning here that as recently as December 2016, a group of MPs, led by Gareth Thomas MP, tabled a Private Members Bill to ‘Mutualise the Royal Bank of Scotland’ (Hansard, 2016). The assumption is that this call will be roundly dismissed, but the case merits attention as a valiant attempt to diversify the UK’s banking sector.

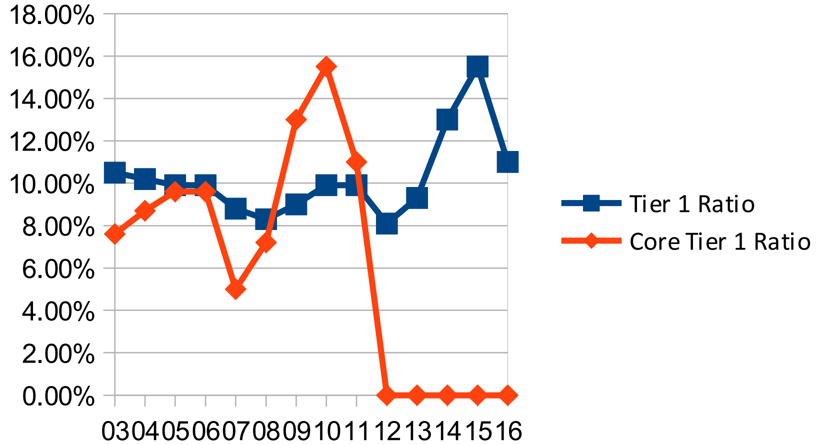
These examples highlight the possibility of remutualisation. However, a move such as this would require the backing of all shareholders and approval from the regulator. It may be difficult to secure this backing from the Co-operative Bank's current hedge fund owners, but this may become a viable political campaign if resolution by the Bank of England becomes necessary.

Appendix 1: An analysis of the Co-operative Bank's Financial Information

Figure 1 plots the ratio of 'Tier 1' capital at the Bank since 2003. Historically the Bank has been comfortably clear of the regulators capital requirements. The chart shows how the Bank recovered well from the 2008/9 financial crisis, even after its capital requirements were raised by Basel III. The Bank started to report on its CET1 capital ratio in 2008, a component of 'Tier 1' capital that consists mostly of common stock held by a bank or other financial institution. Its capital position deteriorated rapidly in 2012 after the Bank restated it's 'Tier 1' and CET1 ratio's in response to the Prudential Regulation Authority (PRA) investigations in 2013. Since the Bank's management overhaul, it is self-evident that CET1 capital, the least risky form of capital, has become the Bank's sole focus in terms of 'Tier' 1 capital. The Bank's most recent decline comes after five consecutive years of statutory losses (Dunkley, 2017).

Further to this graph Fig. 2 shows retail deposits in the Bank since 2007. This is to show the recent decline in deposits at the Bank. Since the PRA intervened in 2013, deposits in the Bank have declined by over £8 billion, with the most significant decline occurring between 2014 and 2015.

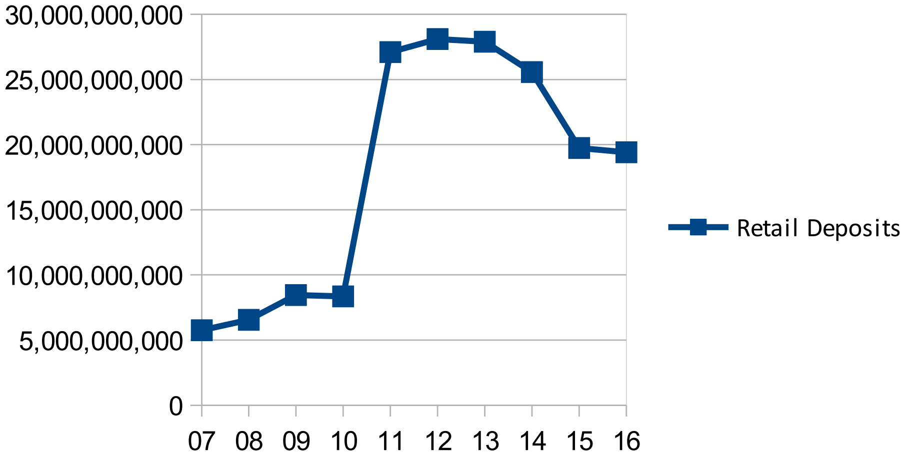
Figures



1.

Taken from the Bank's annual financial reports.

Find at: http://www.co-operativebank.co.uk/investorrelations/financialresults/previous-financial-results



2.

Taken from the Bank's annual financial reports (see above).

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