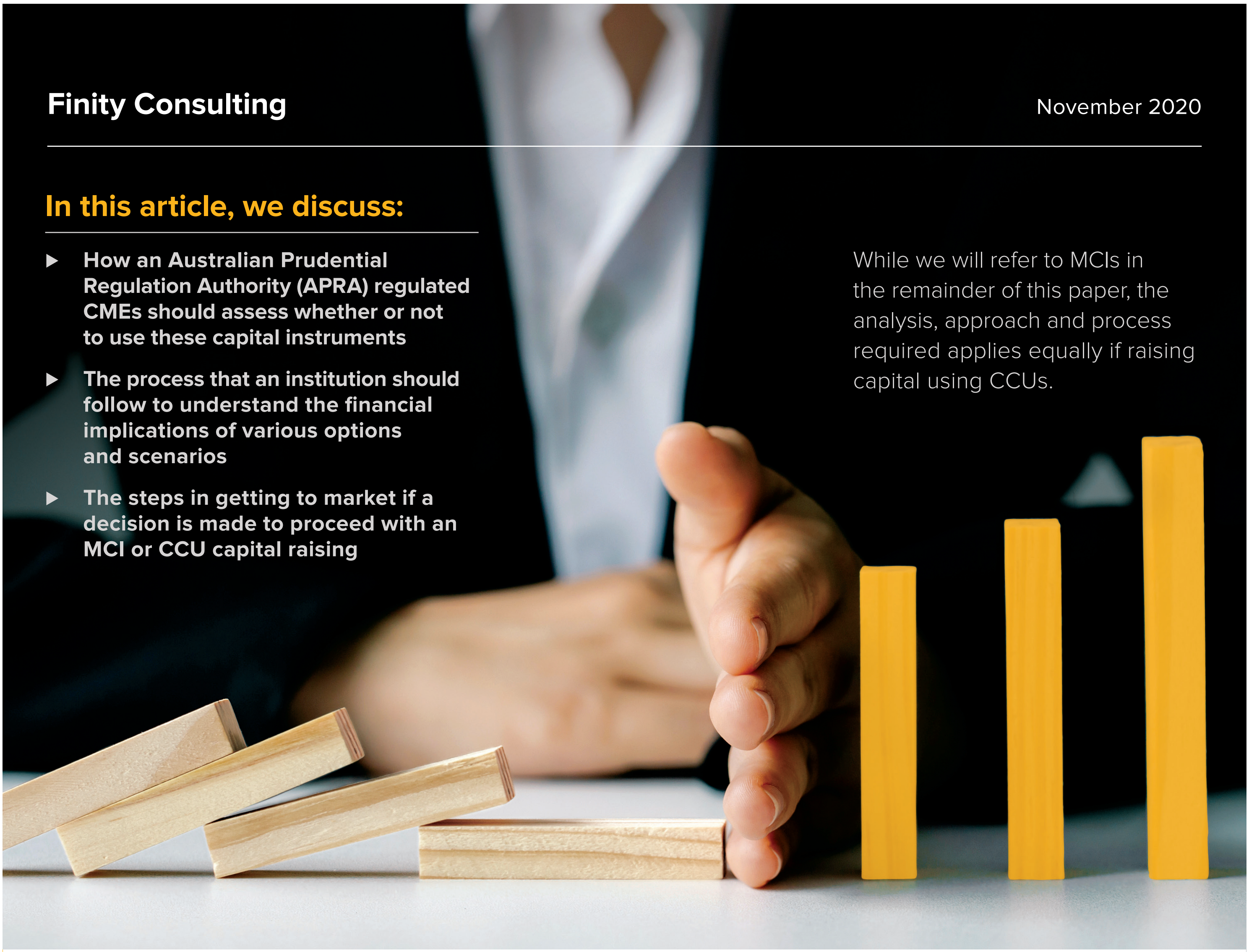


In this article, we discuss:

- **How an Australian Prudential Regulation Authority (APRA) regulated CMEs should assess whether or not to use these capital instruments**
- **The process that an institution should follow to understand the financial implications of various options and scenarios**
- **The steps in getting to market if a decision is made to proceed with an MCI or CCU capital raising**

While we will refer to MCIs in the remainder of this paper, the analysis, approach and process required applies equally if raising capital using CCUs.

A guide to raising capital with MCIs and CCUs

Mutual Capital Instruments (MCI) and Co-operative Capital Units (CCU) provide mutual and cooperative entities (CMEs) with an effective alternative route to financing their growth. For CMEs that are financial institutions, capital provides financial strength and certainty to members. These organisations are required to have strong governance and robust processes for the monitoring and management of capital. Hence introducing MCIs or CCUs into the financing mix requires consideration of how these instruments will impact financial risk.

Background

After a period of substantial lobbying by cooperative and mutual enterprises and supported by recommendations emerging from the Hammond review in 2017, in April 2019 the Federal Parliament passed new legislation that established provisions for “member-based organisations” to issue capital instruments called Mutual Capital Instruments (MCI). The enacted legislation provides a mechanism for Mutual and Cooperative organisations to raise new sources of capital without jeopardising their mutual status under the Corporations Act.

Organisations were provided with a three-year transitional period (ending April 2022) where they can make specific changes to their constitutions to allow for the issuance of MCIs.

Co-operatives have, for some time, been permitted to issue Co-operative Capital Units (CCUs), subject to the legislative frameworks in each state or territory.

This paper addresees the relevant issues for an organisation considering issuing either MCIs or CCUs.

Part 1 – Assessing options

MCIs can fund a range of growth or innovation projects. In developing the business case for them, financial modelling will clarify the future impacts on profitability and capital position. Financial models are an integral part of cash flow projections, scenario analysis, stress testing and dynamic financial analysis. In addition, for CMEs, they are instrumental in establishing confidence that members will not be adversely impacted and are being treated equitably.

With a requirement to maintain target levels of capital, and to have plans around future levels, it is vital to assess the how issuing MCIs will change your approach to capital management. For example, when your institution makes a large strategic investment, the treatment of the investment on the balance sheet is important. Raising capital alters future capital positions and financial strength. As MCIs can count as Common Equity Tier 1 (CET1) capital they may represent a significant change to your institution’s capital management approach.

Consideration should also be given to the institution’s values and mission, risk profile and member preferences, in the form of a qualitative assessment.

	Economic view	Regulatory view
Modelling / Analysis	• Cash flow projections • Qualitative and qualitative risk identification	• Balance sheet and P&L projection • Scenario analysis and Stress Testing • Dynamic Financial Analysis
Metrics	• Net present value • Internal rate of return • Return on equity / Return on assets • Payback period	• CET1 Capital Ratio / Total Capital Ratio • Buffer above Prudential Capital Requirement • Trigger Levels
Key Stakeholders	• Board / Senior Management • Members • Investors	• Board / Senior Management • APRA

Assessing member value and equity

Member value can be defined as the value of services that members receive over and above the value of the fees charged for services. Assessment of projects should focus on broader member value. The Mutual Value Measure measurement framework developed by the Business Council of Cooperatives and Mutuals (BCCM) and Monash University provides a wholistic way to identify and measure the value created across six dimensions that include member and community relationships.

Value to members from a project or investment can be considered in the analysis as either:

- An explicit benefit from the project, or
- An adjustment to the cost of equity that measures return given up to members

The first approach requires an estimated dollar value of benefits that might result from a project or investment. The second approach incorporates a member value hurdle rate used to assess the project.

Undertaking new activities or creating new products will change the risk profile. Your organisation may need to operate more conservatively or restrict activities in the future, which impacts how members are treated. For example a conservative investment policy, mix of new business, or crediting rate policy may potentially be to the detriment of your existing Members.

Where the investment or project is used to create a new product or expand the customer base to a new class of customer, there could be an impact on member equity. Capital contributed by current and past members is being used to provide services and benefits to new members who have not yet contributed any capital. Financial analysis can model the impact across different classes of business or cohorts of Members.

Finity assists Mutuals and Cooperatives in developing communication strategies for their diverse stakeholder groups.

The decision to raise capital using MCIs requires considering complex trade-offs. Our consultants are experienced in communicating complex technical concepts clearly and concisely.

Stakeholder communication

A key component of the assessment is your stakeholder communication. Unlike a shareholder owned entity, your institution will have a broader range of stakeholders who are vested in the future success of your institution. In addition to the Board, your communication strategy needs to consider members, employees and the community.

Assessing your capital instrument requires balancing risk and return over long, time horizons with significant uncertainty. The tools and analysis used to make the decision can be complex, for example, using stress testing or Dynamic Financial Analysis (DFA). A key role of management and their advisors is translating the outcomes of the analysis into a business context that the Board can readily understand.

Members vested in the ongoing success of the mutual will also want to understand the rationale for pursuing a capital raising via MCIs. They will want to understand how you have assessed the impact on the value that they will receive as well as impacts on member equity. The trade-offs that management have considered will need to be communicated in an accessible and relevant way for members.

Capital management considerations

Capital management is linked to the risk taken by your institution and its business plans. Strategic investments that have a significant impact on risk should initiate a review of the capital management framework. For prudentially regulated entities, APRA expects that the Internal Capital Adequacy Assessment Process (ICAAP) is integrated throughout the decision-making processes of the institution. Further, where MCIs are used, the capital composition of the institution will also change.

You will need to review capital buffers, capital triggers and actions associated with triggers.

The ability to raise capital using MCIs can expand the range of strategies open to your institution to source capital. In including MCIs in a capital management toolkit, you need to be confident that you can raise capital in this way as and when required.

Financial modelling

Given the long-term nature of MCI capital, banks and insurers must undertake robust financial modelling. Issuing MCIs creates an expectation of ongoing distributions being made from the mutual's after tax profits. Given the nature of raising MCI capital, you will need to carry out financial modelling to develop forecasts of balance sheet and profit and loss at an enterprise level over a long period of time.

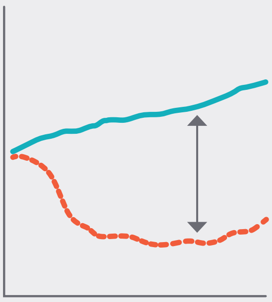
Key output from the projection model would include:

- Revenue and expense base
- NIM / Profit margins
- Return on equity
- Debt Servicing Capability
- Capital and solvency ratios
- Liquidity ratios (ADIs)
- Reinsurance exposure (Insurers)
- Tax position

The model will need to run under a range of structures so that MCIs can be assessed alongside other sources of funding or under alternative valuation methodologies.

Furthermore, its important to understand what the distribution of future outcomes might look like. This requires developing stress testing or dynamic financial analysis (DFA) frameworks, which allow the examination of the range of potential outcomes based on a financial projection model that is calibrated via set of assumptions.

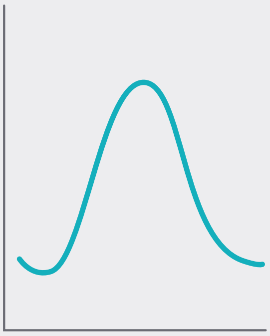
Stress Testing:
Understanding an institution's financial resilience under one or more severe but plausible scenarios. Required by APRA as part of its capital and risk management process.



+ Focus on a few scenarios which provides detailed insights on how an institution copes with a severe downturn and its key vulnerabilities
+ Can test management responses

− Assumptions "are challenging to set for each scenario

Dynamic Financial Analysis:
Understanding the range of outcomes under multiple (often thousands of) scenarios. The distribution of outcomes can be used to understand likelihoods, e.g. likelihood of falling below capital buffers.



+ Understand range of outcomes including both upside and downside
+ Provides view of volatility
+ Can make probabilistic judgements

− Complex to carry out, with more assumptions required
− Results can be more difficult to communicate

Stress testing

Stress testing has been a key risk management tool since the Global Financial Crisis as a way of demonstrating financial resilience and capital adequacy. The test usually starts with a narrative describing the stress event. From this narrative, the institution will set more detailed assumptions to forecast the profit and loss and balance sheet as shown below.

Stress event narrative	Detailed business assumptions	Business projections	Management actions	Review and analysis
Narrative provides broader economic or systemic assumptions such as forecast GDP, cash rate, inflation and unemployment rate.	Business units derive detailed assumptions such as: • Portfolio growth rates • Treasury yield curves • Claim rates • Default rates / downgrades • Net interest margin • Expense ratios	Assumptions are applied to starting assumptions to obtain forecasts of the P&L and Balance sheet statements. This can also include key metrics and ratios e.g. capital ratios.	The model may also incorporate management actions expected in the stressed scenario: • Change pricing • Mix of business • Reinsurance or other risk mitigation	Results are communicated to senior stakeholders and subject to review and challenge.

The process may require iterations to fine-tune assumptions and derive results that can be understood in the context of the scenario. A key challenge is deriving the detailed assumptions, such as making judgements on how customers and markets will react in the stressed scenario. Your institution will already likely have a stress testing framework in use which can be leveraged to carry out analysis when considering the use of MCIs.

Adjustments might include allowances for:

- Expected dividend payments being made to MCI holders from the after-tax profits
- New risks that might arise if the institution uses MCIs to implement strategic projects such as entering new markets or providing a new service
- Changing member expectations regarding services and benefits provided by your institution.

Dynamic Financial Analysis

Dynamic Financial Analysis (DFA) is a quantitative process that assists decision-making and is applicable to a broad range of business problems. DFA constitutes a framework for analysis but also represents a discipline or mind-set that can be instilled across an organisation.

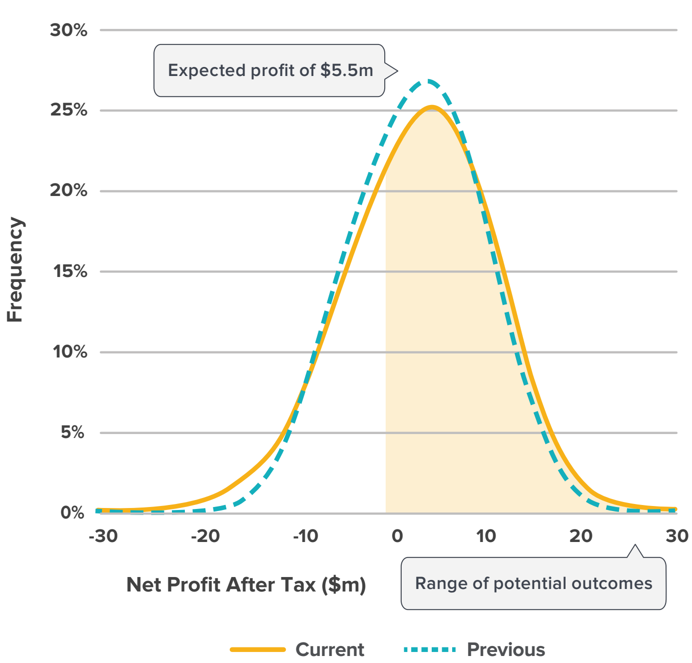
DFA uses multiple, potentially thousands, of randomly generated scenarios. These are run through the projection model. Given the large number of scenarios, assumptions translating each scenario's impact on the institution's cash flows needs to be codified and incorporated in the model. Whilst providing less control over the assumptions, DFA provides detailed insights into how different actions translate into measures such as profit volatility, or the likelihood of breaching capital ratios for example.

As illustrated below, DFA can be used to compare different options such as reinsurance and capital levels, or to understand the impact on a particular risk measure e.g. the probability of breaching a capital trigger.

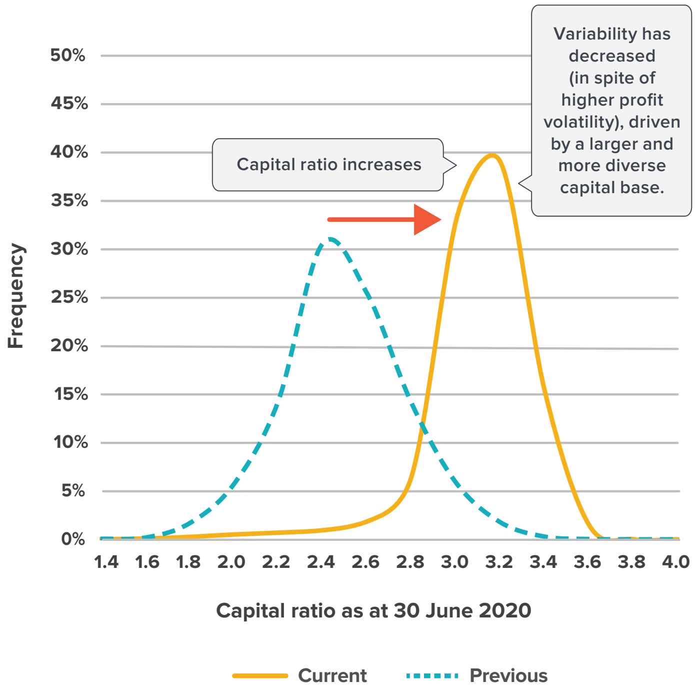
Alternatively, DFA can demonstrate the potential range of losses under different funding options for example, different levels of capital or debt raised to fund a project.

These insights cannot be obtained from limited scenario sets. DFA in particular shows the range of outcomes from different choices when there is uncertainty.

Distribution of Profits (including capital transfers)



Distribution of Capital Ratio



Finity can assist Mutuals and Cooperatives to undertake detailed financial investigations that assist the Board or senior management to understand the potential range of financial outcomes from a strategic investment or by issuing capital instruments to support it.

Finity regularly assists clients in undertaking DFA assignments and is a thought-leader in best-practice DFA techniques.

Part 2 - Going to market

Transaction partners & management

Once the decision has been made to proceed with the MCI or CCU issuance, the first task is to appoint the partners that will work with you over the transaction lifecycle.

These decisions will ultimately affect the success of the issuance.

The primary functions that require partnering include:

- Structuring
- Pricing & market testing
- Deal analysis
- Legal & Compliance
- Taxation
- Disclosure & Documentation
- Underwriting
- Distribution
- Reporting
- Registry services

Managing your transaction partners requires a dedicated effort and the process should be managed independently of any of these individual functions. It requires a strong project-management mindset to orchestrate the various partners to maximise outcomes for members and meet the deal timeline.

A transaction will require one or more financial licensees (AFSL holders) for particular aspects of the capital raising process.

Traditionally the licensee has also taken a role in co-ordinating and providing advice on structuring and pricing issues. Fees for ancillary services will often be bundled into the overall transaction pricing, which is typically a basis point charge on the transaction value. Caution should be given to any conflicts of interest that build up within transaction partners and insist on unbundled fees and advice which is distinguished from any underwriting, distribution or execution services that are also performed.

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Finity can assist Mutuals and Cooperatives during the ‘go-to-market’ phase in managing the various transaction activities and providing strategic oversight to internal steering committees as well as ensuring conflict-free advice is provided to generate the best outcomes for Members from any capital raising.

Structuring

The structuring of the issuance is a key step in the process and one that many mutuals and cooperatives might be unfamiliar with. There are decisions that are made at this point that will impact the issuance, the members and the investors over a long period of time.

Some of these considerations include:

- Retail and/or Wholesale? Wholesale only might be simpler, cheaper and quicker, but it limits the investor base and would potentially exclude many Members of Mutual and Cooperative organisations
- Listed or unlisted?
- Members vs non-members

Structuring requires consideration of the trade-off between the efforts required to access certain markets with the investor base that you are looking to attract.

- Who are the ideal investors to have supporting your Mutual or Cooperative?
- How do you want any issuance to interplay with your membership base?

The issue can be carried out in conjunction with a cooperative of mutual financial institutions. This maybe a viable option particularly for smaller mutuals who do not need to raise large amounts of capital. Organising such a structure will take more time and the mutuals participating need to weigh up pros, such as lower cost, against disadvantages, such as complications when having to redeem the instruments.

Ultimately the transaction needs to consider the best interests of the Members above all else. The structuring process sets up the parameters of the issuance that will be in place until maturity or until the securities are retired. Each structuring decision needs to be assessed by the organisation in terms of the benefits to members and membership equity and should be at arm's length to the other transaction partners who may not have completely aligned interests.

Term sheet and market testing/roadshow

Once structuring considerations have been worked through, attention turns to pricing the securities and planning to roadshow the new issuance.

The issuer will engage their distribution partners to undertake market testing which provides important feedback on:

- buy-side appetite
- indicative pricing
- structuring.

This input might prove useful in refining the structure or deal parameters prior to the roadshow to maximise appeal.

The roadshow is an important step in the marketing process giving the issuer the opportunity to communicate directly with potential investors. For a Mutual or Cooperative it is even more important. Ideally you will be 'road showing' a potential issuance with your Members well before an official roadshow. Bringing them along with you for the journey will improve the chances of success and ideally attract a large number of your Members to become investors in MCIs or CCUs as well.

Pricing

The pricing of new securities is a delicate balance that weighs up the range of supply and demand issues. It will require the holistic valuation of the Mutual or Cooperative – an exercise that may not have been undertaken before.

Securities ***need to be priced high enough that they extract a fair value for Members*** who are essentially selling parts of their organisation rights to a share of future profits, however, no higher than will attract an initial and sustainable demand for the securities.

Market testing is a key component of this process.

Many issuers' reputations have been tarnished from securities that struggle in secondary markets due to overpricing in primary markets. This is particularly sensitive for Members who become holders of these new securities.

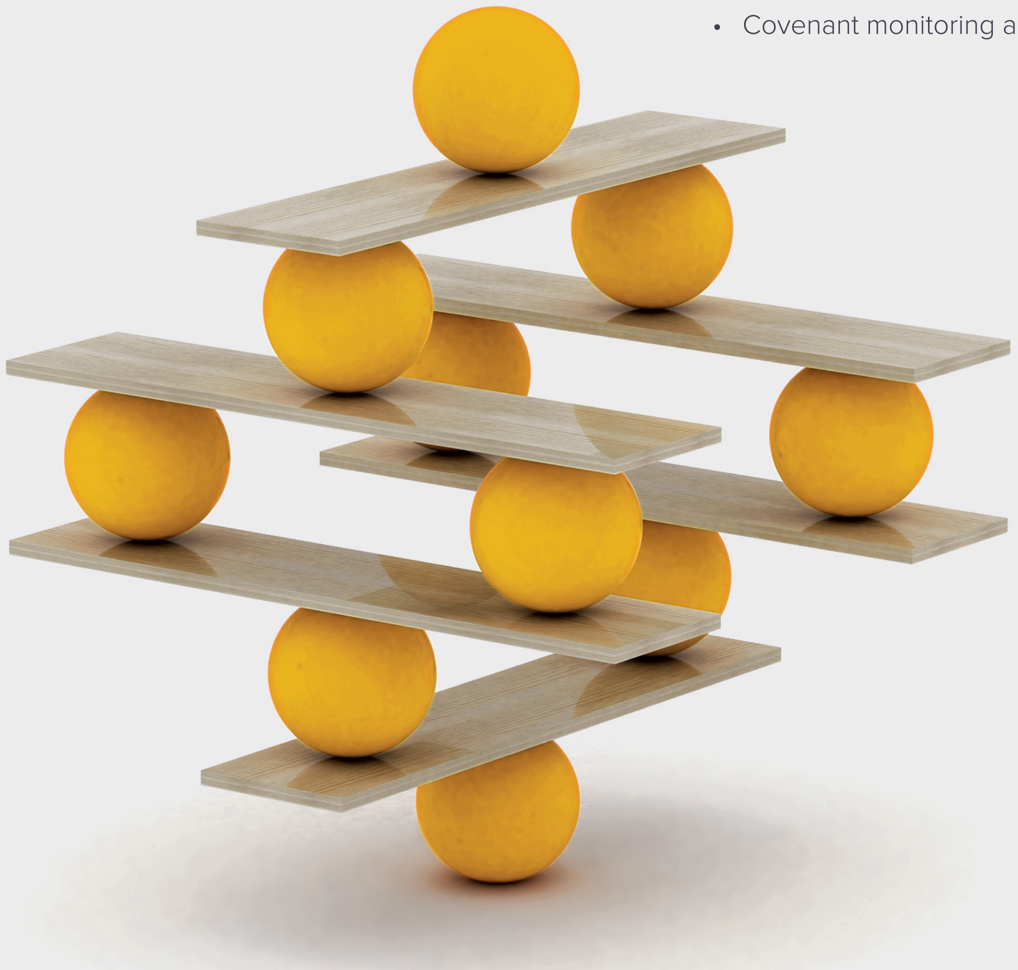
Pricing requires a diversity of approaches and need to look beyond the financials and consider the broader environment in which the organisation is operating.

Transaction administration

Whist the transaction administration does not need to be onerous, it may be an unfamiliar process for many organisations. There are a range of important requirements of regulators, exchanges and investors relating to the disclosure and administration that supports the issue of securities.

There are a number of processes that are generally managed by third party registry service firms, including:

- Maintenance of investor register and transaction report
- Processing of withholding tax
- Administration of ongoing distribution payments
- Covenant monitoring and reporting.



Disclosures & communication

Disclosures are important and depend on the type of issuance, type of investor as well as whether it's listed or unlisted.

Initial offer disclosures are requires as well as ongoing disclosures post transaction-close:

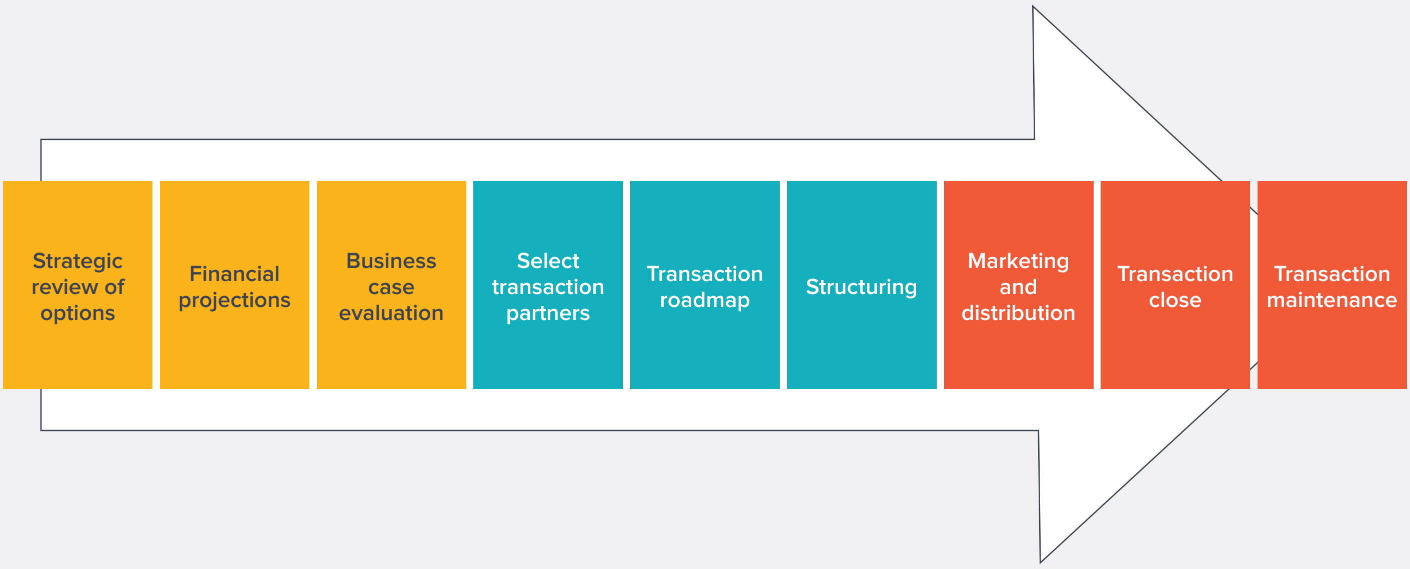
- If listed then need to meet exchange rules - in particular continuous disclosure rules
- APS 330 Public Disclosure outlines the disclosure requirements on ADIs relating to key information that would affect the performance if its securities
- Generally the market expects a listed company to provide guidance, above and beyond the regulatory requirements, to assist in informing the market about is current activities and expectations.

Regular communications with security holders, members and exchanges will assist in the stability of the secondary market for securities and the transparency offered to potential investors in your organisation.

What are your next steps?

Organisations will have different levels of familiarity with raising capital from debt or equity capital markets. As we have outlined in this paper there are a number of important steps to get to market and the nature of being a Mutual brings special considerations. The readiness your organisation to raise capital via MCIs will move through a number of stages; from the early feasibility and business case development, through transaction design and structuring and then finally onto marketing, distribution and transaction maintenance.

Along this journey it is crucial that the transaction is managed effectively and independently from the activities, communicating regularly with management, the Board, members and the broader stakeholders of the mutual or cooperative entity.



About Finity

Finity is Australia's largest independent actuarial and analytical consulting firm. Powered by 180 smart, results-oriented people with deep domain knowledge in insurance, finance, climate risk and health care, Finity provides not only world-class technical skills but a unique perspective across a wide range of business challenges.

We support a wide range of mutuals and cooperatives to better manage their risk, capital and improve profitability.

Working in partnership with CFOs and CROs through to product managers and risk officers we provide access to cutting edge analytics to support revenue, capital and risk based decisions. Finity is a Business Council of Co-operatives Mutual (BCCM) Associate Member and has a wide range of mutual clients including specialist insurers and banks across Australia and New Zealand.

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