THE IMPACT OF REGULATORY GOVERNANCE STANDARDS ON BOARD CHARACTERISTICS:

Evidence from Australian credit unions

LUISA UNDA, Lecturer, Department of Accounting, Monash Business School, Monash University

Credit unions are mutual or cooperative financial institutions owned by members, who are also their customers, depositors and borrowers. Governance of mutuals is based on the democratic principle of 'one member one vote', and directors are drawn from and elected by the membership. This paper examines how regulatory governance standards have shaped the governance practices of Australian credit unions. While credit unions have a very different ethos from that of publicly-traded institutions, they face similar governance challenges, particularly in terms of the need to ensure board competence and effective control over management.

Credit unions in Australia have undergone significant change over recent decades. Increased regulatory requirements, mergers, new products and services, and growing operational sophistication are all occurring within an increasingly competitive market. These changes pose significant challenges for those concerned with the issue of effective governance.

Both credit union membership and financial sophistication have grown in recent years with the Australian mutual sector, including credit unions, mutual banks and building societies, holding AUD 100 billion in assets and serving more than 4 million customers as at September 2016 (Customer Owned Banking Association 2016). According to McKillop and Wilson (2015), the Australian credit union sector is considered to be at a mature stage of development, given their large asset size, loose common bond, professionalisation of management, and diversification of products and services.[1]

This study examines the board governance practices of Australian credit unions and explores the impact of regulatory standards on board characteristics. In 2006, the Australian Prudential Regulation Authority (APRA) introduced prudential governance requirements for all authorised deposit-taking institutions (ADIs) with the aim of ensuring that a regulated institution is managed in a sound and prudent manner by a competent board. At that time, there were concerns within the Australian credit union sector that these governance requirements might not be consistent with the democratic board structure. For example, the requirement for board renewal practices might not recognise the fact that credit unions could benefit strategically from long-tenured directors who are committed to the mutual principles. This raises the question of how the governance of Australian credit unions has evolved in response to both regulatory requirements and market realities over the past 10 years.

Improved governance practices are particularly important for regulators to ensure financial institutions are managed by a board that exercises its role effectively. But are these governance standards consistent with credit unions' democratic governance? The democratic election of the board means that each credit union member has one vote regardless of the size of their investment in the credit union. This creates an issue for owners seeking to exert discipline at the board level.

This research seeks to provide an understanding of the nature and effectiveness of the democratic attributes of credit union boards. Because APRA's governance standards are mandatory, it is important to understand credit unions' response to the introduction of these standards while adhering to their democratic features.

Background

The regulatory standard CPS 510 sets APRA's minimum requirements for good governance of an ADI. The aim of this standard is to ensure that a regulated institution is managed in a sound and prudent manner by a competent board. Although APRA does not clearly specify what a competent board is, it provides a set of requirements that ADIs need to follow to ensure the regulated institution has a strong governance framework. The current CPS 510 standard[2] (effective from January 2015) specifically sets requirements with respect to board: size and composition; independence; renewal; remuneration; and committees.

In particular, it specifies that the board must have a minimum of five directors. In credit unions, board size is primarily influenced by the individual characteristics of the institution, such as its size and the complexity of its operations. The governance standards also require the board to ensure that directors have a full range of skills needed for effective and prudent operation of the institution. This expertise requirement applies to the board as a whole although it does not reduce the responsibility of each individual director. One of the concerns for credit unions when the governance standard was proposed was the difficulties they could face when recruiting qualified directors (Khoo 2005) given the democratic election of the board. Boards are also required to have in place a formal policy on board renewal, as this was not evident in many Australian credit unions at the time when CPS 510 was introduced. Khoo (2005) highlights that this board renewal standard was interpreted by credit unions as APRA targeting long-serving directors.

The governance standard also requires the board to establish a remuneration committee that periodically reviews the remuneration policy, ensuring it remains appropriate for its intended purpose.[3] The key principle of this policy in credit unions is to remunerate directors and senior managers in a manner that takes into account experience, qualifications and performance, while also considering industry benchmarks. The requirement for a remuneration policy, however, fails to recognise that some credit unions have volunteer directors.

Data

The study examines Australian credit unions over the 2004–12 period. Data are available from two sources: publicly available annual reports; and hard copies of annual reports obtained from the Australian Credit Union Archives (ACUA) office in Sydney. Board governance variables were hand collected from the directors' report section. This study focuses on a comprehensive set of board characteristics such as board size, tenure, expertise, remuneration, meeting frequency and attendance at board meetings.

Analysis

This study analyses whether the board structure in credit unions has been shaped by APRA's governance standards. Two time periods are identified and categorised as 'before' the change in APRA standards (i.e. 2004–06) and 'after' (i.e. 2008–12). A one-year gap (2007 observations not included) allows for the CPS 510 standard's effects to flow through to board governance variables. Table 1 presents the sample means for the board variables, the range of values in each time period, and the nonparametric test statistics (*t*-test) for the differences in mean values between the two periods.

The average board size increased slightly over the period after the governance standards came into effect, which is in line with the minimum of five directors mandated by APRA. When compared to bank board size, credit union boards are much smaller. For instance, in 2012, the big four banks in Australia had an average board of 11 members. Thus, the small board size in credit unions appears to reflect their relatively small size.

No significant changes in board gender diversity occurred as a result of the introduction of the CPS 510 standard. Women continue to be underrepresented on credit union boards relative to Australian banks; on average, 22 per cent of directors on bank boards are female. Board gender diversity in Australian credit unions is also lower than that reported by Goth et al. (2010) for a sample of Canadian and US credit unions, i.e. 30.8 per cent and 29.2 per cent, respectively.

TABLE 1: Board structure and governance standards

	Before APRA standards		After APRA standards		(*t*-test)
	Mean	Range (min to max)	Mean	Range (min to max)	
Board size	7.94	[5 – 14]	8.22	[5 – 14]	(2.58)***
Female	16.78	[0 – 71]	18.15	[0 – 57]	(1.39)
Tenure	11.04	[2 – 27]	10.42	[2 – 27]	(2.31)***
Financial expertise	16.90	[0 – 18]	49.19	[0 – 52]	(10.80)***
Paid boards	83.38	[0 – 84]	91.33	[0 – 92]	(3.36)***
Meetings	13.18	[8 – 31]	12.60	[6 – 31]	(3.55)***
Attendance	86.59	[62 – 100]	88.14	[53 – 100]	(4.12)***
Sample	343	343	496	496	

Board size is the number of directors on the board. Female is the percentage of directors who are female. Tenure is the average number of years directors have served on the board. Financial expertise is a dummy variable coded 1 if the credit union has at least one director with accounting and/or financial expertise on the board, and 0 otherwise. Paid boards is a dummy variable coded 1 if the credit union pays a fee to directors, and 0 otherwise. Meetings is the number of board meetings. Attendance is the weighted average of the number of meetings attended by directors as a percentage of the total number of meetings held.

Board tenure has declined consistent with the regulatory requirement aimed at ensuring that boards are open to fresh ideas and new perspectives. This decline was either due to the appointment of new directors or the retirement of existing directors or both. Changes in directors' tenure are more evident in the later years, when the majority of Australian credit unions experienced a marked decrease in board tenure. For instance, in 2012, roughly half of all Australian credit unions experienced a 33 per cent decrease in board tenure, compared to 2004. Recent annual reports provide evidence that elected directors are appointed for a period of three years, and that they can stand for re-election for two additional terms. Thus, in total, a director serves on the board for a maximum of nine years, which is consistent with the Australian Institute of Company Directors' (AICD) good governance principles. Nonetheless, the average tenure of credit union directors is higher than that of bank directors (5.41 years).

Directors' financial expertise has significantly improved, consistent with the objective of regulators. The proportion of credit union boards with financial expertise (49.19 per cent) is relatively close to that of the big four bank boards (62.9 per cent). Credit unions have made significant efforts to elect board members with the required financial expertise, by either electing qualified directors or providing training to existing ones. The most common qualification in accounting is CPA, and the other source of financial expertise most commonly sought-after is work experience as banker or financial analyst.

The expansion of the common bond of association may have also contributed to increased expertise as credit unions are able to recruit directors from outside their traditional membership base. For those credit unions without a restriction on the bond of association, the proportion of boards with at least one accounting/financial expert (69.8 per cent) following the introduction of governance regulation is significantly higher than for those credit unions with a restrictive bond (44.5 per cent). Nonetheless, this redesign of directors' appointment carries some risk in that it might result in a qualified board that does not function within the cooperative philosophical framework.

The number of volunteer credit union boards has dropped significantly in the period after the introduction of governance standards, particularly during 2006, which saw a decline from 23 to 11. The governance standards are likely to have raised concerns about the viability of volunteer boards and led to greater remuneration of directors, with credit unions attempting to recruit more qualified individuals and/or directors demanding higher compensation for increased obligations. Directors' pay tends to reflect the level of expectations from board members. This is particularly relevant in a competitive environment when there are greater compliance requirements and increasing expectations of directors and their ability to effectively monitor management and assess the institution's risks. During the sample period, the total remuneration for credit union boards is, on average, $119,289, which represents only 5 per cent of the average total remuneration of bank boards.

In the period after the introduction of governance standards there has been a significant shift from volunteer to paid boards, an increase in the financial expertise of directors, larger boards, reduced tenure of directors, and greater attendance at board meetings. It appears that regulation has positively affected credit union board practices.

Table 1 also shows that after the adoption of governance standards, the frequency of board meetings decreased, and the attendance at those meetings increased. This highlights improved board functioning through more effective board meetings. The maximum frequency is 31 meetings per year, which is higher in the early years of the sample, for credit unions with poor performance that were subject to mergers. The average number of board meetings suggests that boards meet approximately once a month. This includes the annual general meeting, where the election of board members takes place. Further, the commitment to the credit union values may play a significant role in the higher attendance records reported after the governance standards; however, credit union board attendance is lower than that reported for bank board meetings (98.6 per cent).

Overall, the data in Table 1 suggest that board structure in Australian credit unions has been shaped by regulatory governance standards. In the period after the introduction of governance standards there has been a significant shift from volunteer to paid boards, an increase in the financial expertise of directors, larger boards, reduced tenure of directors, and greater attendance at board meetings. It appears that regulation has positively affected credit union board practices.

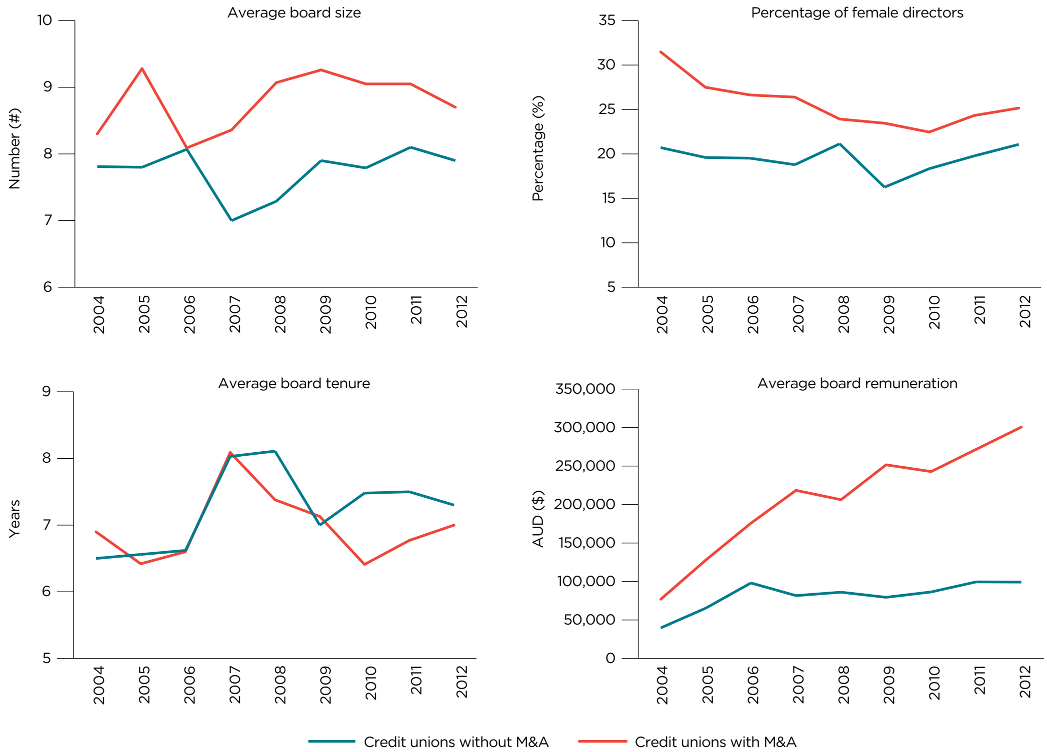
Merger activity

The changes in board characteristics might also be partly due to the continuous trend of merger and acquisition (M&A) activity in the Australian credit union industry over the past two decades as credit unions have pursued economies of scale, or simply sought to survive. Simultaneous to this M&A activity, the number of credit unions has declined (Brown et al. 1999; Davis 2005; Ralston 2001; Worthington 2004), falling from 345 in 1990 to 224 in 2000, and from 179 in 2004 to 94 in 2012. On average, 22.5 per cent of Australian credit unions (either as acquiree or acquirer) engaged in M&A activity during the 2004–12 period.

Arguably, such dynamics could have had a direct impact on the governance of credit unions. For instance, the significant decrease in board tenure may have been due as much to mergers (where long-tenured directors were not re-elected) as the renewal practices adopted as a consequence of mandatory governance standards. It could also be that directors from the acquiree credit unions were considered as new directors for the acquirer credit union, so their tenure was not accumulated.

This study explores and controls for the effect of mergers on board structure. The results indicate that credit unions with previous M&A activity have larger boards, a higher percentage of female directors, lower board tenure, and have higher levels of remuneration for directors (see Figure 1). Larger boards are expected in credit unions that have been subject to mergers, particularly in the years following the merger. The bank governance literature provides evidence that boards typically grow after M&A activity (Adams and Mehran 2012; Pathan and Skully 2010). The findings of this study confirm this argument and reveal that the average board size for credit unions that have been subject to mergers during the 2004–12 period is 8.5 members, which is larger than the average board size (7.9 members) for credit unions without mergers. Board size is positively correlated with board gender diversity, suggesting that female directors are more likely to be found in larger boards. A higher percentage of female directors is found for credit unions involved in mergers.

FIGURE 1: Board structure and M&A activity



See Table 1 for variable definitions.

M&A activity is also associated with a decrease in the board tenure of the surviving credit union, suggesting that long-tenured directors are less likely to be re-elected by the acquiring credit union. Finally, total remuneration paid to directors is higher for those credit unions with previous mergers. The data also indicates that following the merger unpaid boards were replaced by paid boards. In fact, 44.73 per cent of credit unions with volunteer boards in 2004 engaged in merger activities in the subsequent years. In most cases, the acquirer credit union paid remuneration to its board. This finding could also be explained by the relatively large size of credit unions with M&A activity. Board remuneration for larger credit unions is significantly higher than for smaller credit unions. Overall, these results provide some evidence that M&A activity has also been a determinant of credit union board characteristics.

Conclusions

The findings of this research suggest that regulatory governance requirements have had a positive effect on credit union board practices. In particular, the increased financial expertise of boards demonstrates the efforts made by Australian credit unions to appoint qualified directors. Contrary to the volunteer nature of mutuals, the majority of Australian credit unions remunerate their directors, and boards are relatively small in size but are still compliant with regulatory standards. Governance standards have also reduced the frequency of board meetings and have contributed to improved attendance records. These results highlight the efficacy of regulation in promoting effective board practices.

This study also reports that the changes in board characteristics have been influenced by the continuous M&A activity in the Australian credit union sector. The average tenure of board members has decreased for those credit unions influenced by M&A activity. Mergers have also contributed to larger boards and increased board gender diversity.

Overall, these results provide evidence that Australian credit unions have undergone a redesign of board governance, shifting away from truly cooperative/democratic governance towards a board structure that has been shaped by regulatory governance standards and M&A activity and consolidation.

These findings contribute to a better understanding of board governance in a mature credit union sector and provide important feedback to regulators and other credit union industries worldwide as they assess the evolution of board practices.

Overall, these results provide evidence that Australian credit unions have undergone a redesign of board governance, shifting away from truly cooperative/democratic governance towards a board structure that has been shaped by regulatory governance standards and M&A activity and consolidation.

Notes

1. There are three growth stages in credit unions, namely the nascent, transition and mature stages (Ferguson and McKillop 1997, 2000).
2. Four changes have been made to the CPS510 governance standard since it was first issued in 2006.
3. ADIs must also have a board audit committee and a board risk committee. This study focuses only on the board as a whole.

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