

CONVERSIONS AND CAPITAL OF MUTUAL THRIFTS: CONNECTIONS, PROBLEMS, AND PROPOSALS FOR CREDIT UNIONS

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The history of conversions of mutual thrifts to stock thrifts provides important perspectives on more recent credit union conversions. From the middle 1970s to the early 1990s, undercapitalized mutual thrifts used conversions to raise capital. Since then, however, converting thrifts typically already had considerable capital and economic value, which was transferred from mutuals' members to insiders and outside investors. Long-ignored proposals addressed the capital and conversion problems of mutual thrifts, as well as of credit unions. In 1977, the US Government Accounting Office proposed that, in lieu of converting, mutual thrifts be allowed to count some bonds as capital. In 1973, the Federal Home Loan Bank Board proposed that, to avoid unwarranted transfers of wealth, converting mutuals should distribute stock on the basis of members' deposit histories.

Conversions of credit unions to other depository institutions (depositories) are a recent phenomenon. The first conversion of a credit union to a mutual thrift took place in 1995; the first conversion of a former credit union, that had become a mutual thrift, to a stock-owned thrift took place in 1999. So far, only about thirty credit unions have converted and their aggregated assets at conversion would amount to less than 1 percent of those in the credit union industry in 2010. However, there has been an upsurge in interest recently in converting, and interest has been especially pronounced at larger, more successful credit unions. Much noticed by the credit union industry and its regulators is that conversions of larger, more successful thrifts transferred significant amounts of wealth from their members and reduced the

size and overall health of their industry. Thus, evaluating the causes and effects of thrift and credit union conversions, as well as evaluating longstanding and new reform proposals, is timely.

Although few credit unions have converted so far, the history of mutual to stock conversions of thrifts shows the possible scope for conversions. Conversions effectively decimated the number of mutual thrifts and their market shares. From 1974, when the Federal Home Loan Bank Board (FHLBB) introduced the current "standard conversion model" to 1995, the number of mutual thrifts declined dramatically from 3,856 to 979. Concomitantly, mutual thrifts' share of total (mutual plus stock) thrift assets plummeted from 84 percent to 17 percent; their share of total assets in depositories (i.e., commercial banks, all thrifts, plus credit unions) fell from 22 percent to 3.1 percent. (Credit unions' share rose from 2.2 percent to 5.6 percent then.)

Despite their different histories to date, most of the important problems and reform proposals regarding thrift conversions apply similarly to credit union conversions. Three points that have been made in the literature on thrift conversions are especially germane. First, the standard conversion model sought to prevent deposits' flowing to mutual thrifts that were expected to convert.¹ Second, the standard conversion model sought to raise capital for the mutual thrifts that were undercapitalized.² Third, when mutual thrifts had considerable capital and economic value, standard conversions had the effect of transferring most of that wealth from the typical member to insiders and outside investors.³

The more recent literature on credit union conversions makes two germane points. First, most credit unions that have converted to mutual thrifts were already well capitalized and they then subsequently converted to stock thrifts. These two-stage conversions of credit unions then raised similar concerns about wealth transfers from members (of former credit unions) to insiders and outside investors.⁴ Second, after converting, former credit unions tended to raise their loan rates and lower their deposit rates, which taken alone worked to the detriment of former members.⁵

Here, we show the pertinence of the history and literature of thrift conversions to credit union conversions. We also show that government policies built up the pressures to convert, both by what they did to the economy, and thereby to thrifts, and by how they precluded thrifts from then responding to their predicaments. We make the case that higher inflation, and thus higher market (or nominal as opposed to real) interest rates, during the 1970s and early 1980s inexorably led to depleted capital at mutual thrifts. We also argue that sensible reforms were proposed that could have reduced both the pressures to convert and the problem of wealth transfers at converting mutuals.

These reforms, if implemented, would have ameliorated, if not completely eliminated, the pressures for and transfers in conversions. More specifically, mutual thrifts might have eschewed conversions and rebuilt their financial condition if, as proposed by the US Government Accounting Office (GAO) in 1977, they had been permitted to raise capital by issuing subordinated debt. Because subordinated debts are bonds that are paid, upon

failure of a depository, only after (i.e., subordinate to) depositors and their insurer are paid in full, they can be a form of loss-bearing capital that is akin to the net worth or equity of a stock-owned business or depository.⁶ In addition, the transfers of wealth from typical members would likely be greatly reduced, if not eliminated, if a 1973 FHLBB proposal had been in force. That proposal called for converting mutual thrifts to distribute all of the newly-issued stock at no cost to their owner-members on the basis of each member's deposit history.

Some differences between mutual thrifts, stock thrifts, and credit unions

Depositories operate under charters (e.g., commercial banks, thrifts, and credit unions) issued by various government entities (e.g., state or federal agencies). Depositories may be either stock owned, as is common for other businesses, or mutually-owned by their members. Charters and ownership form affect which agencies, regulations, powers, and governance structures pertain to a depository.

The term "thrifts" includes savings banks and savings and loan (S&L) associations. Savings banks trace their origins to state-chartered philanthropic institutions that encouraged saving (thrift) by the poor and working classes. Following a tidal wave of bank failures in the Great Depression, the Banking Act of 1933⁷ established the Federal Deposit Insurance Corporation (FDIC) as the deposit insurer and federal regulator for savings banks. (The FDIC also insured deposits at commercial banks.) S&Ls arose as state-chartered mutual associations that funded the building and purchase of houses by their members. In 1932, Congress passed the National Housing Act,⁸ which established the FHLBB as the federal regulator for S&Ls. The Act also created a federal charter for thrifts. The distinctions between the powers, assets and liabilities, and names of savings banks and those of S&Ls dwindled over the decades. By the 1970s, most of the important distinctions had all but disappeared. As a result of the thrift crisis, the newly-created Office of Thrift Supervision (OTS) took over the functions of the FHLBB in 1989. After a similarly ignominious performance by the OTS, the Dodd-Frank Act of 2010⁹ folded the OTS into the US Office of the Comptroller of the Currency (OCC) in July 2011.

Stock-owned commercial banks and thrifts provide financial services (e.g., loans, deposit accounts, and so on) to customers, who may or not own their stock. The owners of bank or thrift stock, who may or may not be customers, own and control their banks and thrifts. Stock owners may buy and sell shares of stock, vote in elections of boards of directors in proportion to their shares of stock, and receive dividends on their shares.

In contrast, in general, mutually-owned thrifts are owned and controlled by their members, who can cast votes in director elections, based on their deposits. (Customers must also be members.) For example, a member may have one vote per \$100 in deposits, but thrifts typically cap the number of votes per member at some number between 50 and 1000. Stock-owned depositories presumably maximize the well-being of their owners (who

typically would not be their customers) via dividends. In contrast, mutually-owned depositories may maximize the well-being of their member-customers (who are also their owners) via lower loan rates and higher rates on deposits.

Inspired by similar institutions in Germany and Canada, the first credit union in the US opened in 1911. Credit unions have specific government (federal or state) charters, regulations, and regulators. Until the 1970s, most credit unions originated few mortgages or business loans. Instead they focused on shorter-term consumer lending. In practice, the main difference between credit unions' cooperative structure and mutual thrifts' mutual structure has been the number of votes that each member has for elections of directors. All credit unions applied one-member, one-vote rules. In contrast, mutual thrifts typically linked votes to deposits somewhat. However, to accommodate converting credit unions, in 1998 the OTS began to permit thrifts to also apply one-member, one-vote rules.¹⁰

Rising inflation and interest rates and falling capital at mutual thrifts

Both stock and mutual thrifts suffered losses during the 1970s and 1980s. Losses stemmed from higher and more volatile interest rates, government incentives for thrifts to borrow short and lend long, government ceilings on interest rates, thrifts' forays into riskier lending, and, in some cases, outright fraud.¹¹ By the end of the 1980s, the "thrift crisis" had resulted in thousands of thrift failures. Losses depleted the book, or accounting, values of their capital. Because thrifts were essentially locked into earning low interest income from the mortgages they had made previously, continuing high deposit interest rates meant that thrifts were destined to incur even more losses in the coming years. Thus, the market, or economic, values of their capital declined even faster and deeper than their book values of capital.¹²

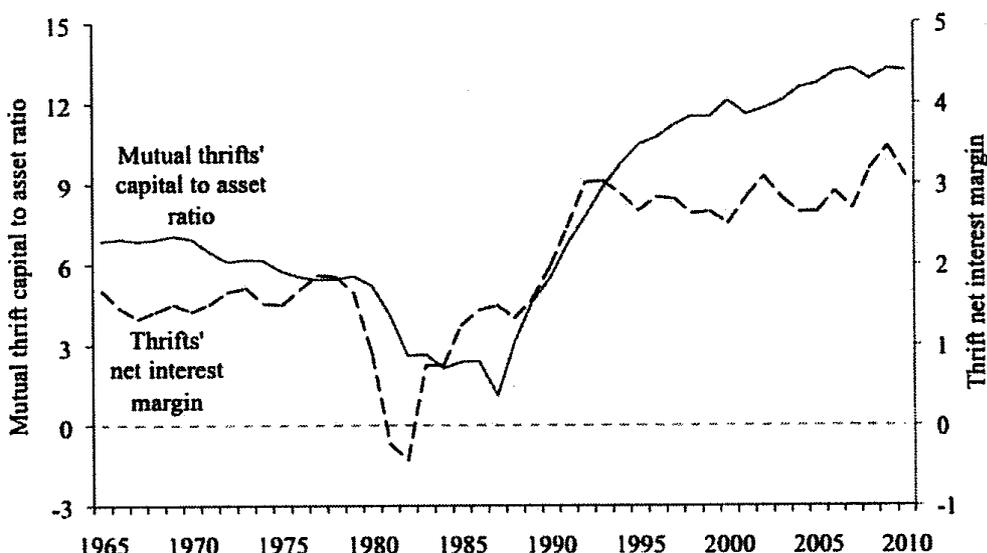
To channel resources into housing, government policies gave thrifts incentives to offer long-term (e.g., 30 year), fixed-rate mortgages. At the same time, thrifts were funded with deposits that had far shorter maturities, such as 30 days, after which a deposit's interest rate would be reset at the new, prevailing interest rate. Such a maturity mismatch can be profitable if deposit rates remain below mortgage rates.¹³ From the late 1960s to the early 1980s, however, the Federal Reserve's monetary policy resulted in rising inflation. Interest rates, both short and long, also rose. For instance, interest rates on newly-originated 30-year fixed-rate mortgages rose from 5.8 percent in 1965 to 8.2 percent in 1970, from 7.4 percent in 1972 to 9.2 percent in 1974, and from 8.8 percent in 1977 to a monthly peak of 18.4 percent in 1981. Deposit rates rose similarly and sometimes more. But, the mismatch problem is that, although the average interest rates on a thrift's existing (long-term) mortgages barely changed from year to year, its deposit rates quickly followed changes in market rates.

34 A simple example shows the effects on a thrift's capital from a sudden increase in interest rates. Consider a (mutual) thrift that started with \$70 million of fixed-rate mortgages that had average maturities of 5 years (e.g.,

\$7 million in mortgages that matured in each of years one through ten), \$30 million of short-term (or variable-rate) assets, \$93 million of short-term (and, thus, variable-rate) liabilities, \$7 million of retained earnings (i.e., capital), \$3 million of annual noninterest expenses, and \$1 million of annual earnings (i.e., net income). Suppose that all interest rates rise 2 percentage points over each of the next five years, followed by five years of similar declines. As interest rates rise, the mutual thrift receives more interest on its new loans that it makes as its relatively few short-term assets mature. But, it pays the higher interest rate on its many more short-term (variable-rate) liabilities. It also earns more interest income when its many, fixed-rate assets gradually mature and are replaced by assets that earn the prevailing, higher interest rates. As a consequence, higher interest rates produce losses at the thrift. In this example, within six years, the mutual thrift's capital ratio would fall by 12 percentage points, from 7 percent to -5 percent, rendering the thrift not just seriously undercapitalized, but insolvent.

Figure 1 shows thrifts' (industrywide) net interest margin (i.e., interest income minus interest expense, as a percent of their assets) and mutual thrifts' capital to asset ratio for 1965-2010.¹⁴ During the late 1960s and much of the 1970s, modest increases in interest rates reduced net interest margins. At the same time, capital ratios fell from about 7 percent in 1970 to about 5 percent in 1980. Sharp increases in interest rates during the late 1970s and early 1980s sharply reduced industrywide capital: the capital ratio halved to about two-and-a-half percent in 1982. Despite higher net interest margins, large losses on loans starting in the middle of the 1980s kept reducing mutual thrifts' capital ratios until they bottomed out at 1 percent in 1987.

Figure 1: Thrifts' net interest margin and mutual thrifts' capital to asset ratio (% , 1965-2010)



Sources: FHLBB (1988), OTS (1998 and 2011).

Faced with such low capital ratios at mutual thrifts and the resulting possibilities for vastly more failing institutions and losses for their deposit insurance fund, regulators began searching for ways for thrifts to rebuild their capital. Depositories routinely rely on retaining earnings to add to their capital. Depositories sometimes sell securities to investors to finance acquisitions or expansions or to restore capital ratios that were reduced by loan losses or by asset growth. Regulators permit depositories to use different categories of securities to meet capital requirements. For instance, regulators routinely permit, and occasionally require, stock depositories to issue new shares of common stock to bolster their capital ratios.¹⁵ Because common stock conveys voting rights to investors, mutual thrifts cannot issue common stock and still remain mutual. Indeed, proponents of mutual-to-stock conversions routinely argue that the inability to issue stock as a means of raising capital is a major disadvantage of the mutual form.¹⁶ Although mutual thrifts cannot issue stock, regulators could permit them to count other nonvoting securities as capital. In fact, a 1977 GAO report pointed out that while the FHLBB did not allow S&Ls to count subordinated debt as capital, the FDIC did allow savings banks to do so.

Permitting mutual S&Ls to count nonvoting securities as capital would have permitted them to raise capital while remaining mutuals. However, the FHLBB stuck to the position that it enunciated before Congress in 1972: moving toward a more modern financial system meant mutual thrifts' converting to stock ownership.¹⁷ As thrifts' capital plummeted, the FHLBB refused to grant mutual thrifts the ability to recapitalize by issuing nonvoting securities. Instead, the FHLBB used their depleted capital as a reason to argue that mutual thrifts should convert.

Conversion models: free distribution and standard conversion

The Home Owners Loan Act (HOLA) of 1933, as amended in 1948, permitted federally-chartered (mutual) thrifts to convert to state-chartered (mutual or stock) thrifts.¹⁸ Mutual-to-stock conversions, however, remained controversial and rare for decades thereafter. The FHLBB introduced conversion regulations in 1955 and again in 1961, but both sets of regulations largely went unimplemented.

The 1961 FHLBB regulations,¹⁹ for instance, required the following for conversions: (1) members holding a minimum of two-thirds of deposits participate in the conversion vote, (2) two-thirds of votes are cast in favor, (3) the thrift distributes its pre-conversion net worth as cash among its members in proportion to their deposits, and (4) the thrift sells shares of common stock worth at least 5 percent of its deposits. (Members could use their cash distributions to buy the newly-issued stock.) These regulations are an application of the "free distribution model," whereby thrifts distribute their net worth at no cost (i.e., free) to all of their current members, who were in fact the mutuals' owners.

36 Figure 2 presents a simple example of a conversion under this version of the free distribution model (all figures in millions). Panel A presents a mutual

thrift whose members jointly own its net worth.²⁰ Panel B presents the thrift following the conversion, for a case in which the thrift sold shares of stock equal in value to its pre-conversion net worth, and all the members used their cash distributions to buy all the shares of stock. Then, the conversion would simply transform the members' collective ownership of the mutual thrift's net worth into the same investors' individual ownership of the shares of stock in the converted thrift. The same individuals would own the entire thrift before and after the conversion.

Figure 2: A simple example of a conversion under the free distribution model

Panel A Mutual thrift before conversion		Panel B Converted stock thrift	
Assets	100	Assets	100
	Deposits 94		Deposits 94
	Net worth (Retained earnings) 6		Common stock 6

Regulations neither (1) required members to buy stock, (2) required the amount of stock on sale to equal the pre-conversion net worth (as long as it exceeded 5 percent of deposits), (3) forbade non-members from buying stock, nor (4) forbade members from buying stock in excess of their proportion of deposits.

Having promulgated regulations for conversions, the FHLBB then superseded them by placing moratoria on conversions of thrifts that were insured by its Federal Savings and Loan Insurance Corporation (FSLIC). The first moratorium prevented conversions for 1955-1961; the second prevented conversions for 1963-1974.²¹ The FHLBB placed moratoria on conversions in response to Congressional concerns, which included (1) that depositors who had withdrawn from the institution recently would get nothing, that recent depositors would get the same as long-time depositors, and that "professional depositors" could open accounts to receive windfall gains; (2) that depositors might destabilize depositories by moving funds just before expected conversion windfalls took place; and (3) that conversions could be initiated and manipulated by managers and directors to their own benefit at the expense of uninformed members.²²

In 1974, the FHLBB adopted regulations²³ that ended its conversion moratorium. To address Congressional concerns, the regulations replaced the free distribution model with the "standard conversion model," which prevails to this day. To reduce depositors' incentive to move funds to thrifts that were expected to soon convert, the FHLBB forbade converting thrifts from distributing their net worth costlessly to their members. Instead, members could only be given nontransferable rights to buy stock on a priority basis.²⁴ So that conversions would necessarily raise thrifts' capital, the FHLBB required them to sell common stock in amounts equal to the independently-appraised fair market value of the pre-conversion thrift.²⁵ To ease conversions, the FHLBB

also changed the dual requirement that depositors holding two thirds of deposits participate in the vote and that two thirds of votes favor conversion to the sole requirement that the majority of eligible votes favor conversion.

Wealth transfers in the standard conversion model

The standard conversion model did reduce depositors' incentive to move funds to thrifts that were expected to soon convert. However, it simultaneously prevented long-time members from receiving distributions of the mutuals' net worth that they had helped to build through years of borrowing and depositing. Moreover, the standard conversion model did not eliminate windfall gains, but simply shifted them from a more transparent form that typical depositors could see, i.e., cash, to a less transparent form that only more sophisticated investors would recognize, i.e., the appreciation of thrift stock prices following their initial public offerings (IPOs). In effect, the standard conversion model transfers the pre-existing economic value of a mutual thrift from all its members to more sophisticated investors, including especially insiders (managers and directors) and outside investors.

Figure 3 presents a simple example of a conversion under the standard model (all figures in millions of dollars). Panel A presents a mutual thrift whose members jointly own its net worth (here, for simplicity, also equal to its total economic value). Panel B presents the thrift following the conversion. We assume, for simplicity, that an independent appraisal determined the thrift's fair value to be \$6 million, and, thus, that the thrift sold \$6 million worth of common stock in its IPO.

Figure 3: A simple example of a conversion under the standard model

Panel A Mutual thrift before conversion		Panel B Converted stock thrift	
Assets	100	Assets	100
	Deposits 94	Additional assets	6
	Net worth (retained earnings) 6		Deposits 94
			Retained earnings 6
			Common stock 6

Under the standard conversion model, the thrift distributes none of its pre-conversion net worth to members in the form of cash. Instead, all of those who invested in the newly issued stock would then own all of the equity²⁶ of the converted thrift. Upon conversion, the equity then consists of the new \$6 million that they contributed by purchasing the newly-issued common stock plus the previously existing net worth (i.e., retained earnings) of \$6 million that the former mutual thrift had accumulated over its entire existence. Investors then could see that investing \$6 million immediately gave them a thrift that had equity of \$12 million.

If all members bought all of the newly issued stock in proportion to their deposits, their claims on the thrift's pre-existing economic value would be substituted *pro rata* by individual stock holdings. The members who bought stock (i.e., buying members) would then have claims on the total equity of the converted thrift. That is, they would own both the cash that they just contributed and their *pro rata* share of the retained earnings. That would somewhat mimic the result of the free distribution model. By investing \$6 million, members then would entirely own a thrift that had equity of \$12 million, which is the \$6 million net worth of the thrift that members had mutually owned plus the additional \$6 million that they invested.

However, if members (as a group) buy none of the newly-issued stock, then they effectively surrender their claims on the thrift's economic value. Then, the economic value accrues to the outside investors who buy stock. Famed investor Peter Lynch described conversions, colorfully, as follows: "buying stock in a converting mutual is like going to an automobile dealer to buy a car, giving him a check for the purchase price, and discovering on the way home that the dealer has put the check in the glove compartment of the car...this is bound to be a good deal."²⁷

Historically, very small fractions of members (under 5 percent) buy stock in conversions.²⁸ When, for instance, members who own 95 percent of the mutual's deposits buy no stock (henceforth: non-buying members), other members who do buy stock in excess of their *pro rata* share and outside investors lay claim to the 95 percent of economic value forgone by non-buying members. In contrast to most members, well-informed insiders (e.g., managers and directors) typically buy a large fraction of the stock in conversion IPOs.²⁹

The transfer of economic value from non-buying members to buying members and outside investors is achieved, in part, via the large gains in the price of the stock in the first day of trading ("first-day pops"). Consider three examples. If a mutual with \$10 million of retained earnings sold \$10 million of stock, the buyers of shares would pay \$10 million and have claims on \$20 million worth of equity. If financial markets recognize that a share sold for \$10 at its IPO is worth \$20, the buyer receives a return of 100 percent on a single day. If the same thrift had sold shares for only \$1 million of stock, the buyers would have claims on \$11 million, and receive a return of 1,000 percent. Even if that thrift sold \$1,000 million of stock, the buyers would still have claims on more than they contributed (\$1,010 million) and receive a return of 1 percent. As long as the pre-conversion mutual has any positive economic value, buyers should theoretically experience a first-day pop. The evidence supports that conclusion. Cox and Roden report that first-day pops in conversion IPOs are, on average, twice as large as in non-conversion, or conventional, IPOs.³⁰

The basic connection between pre-conversion net worth and first-day pops provides a prism through which to assess the standard conversion model over time. Troubled mutuals, by definition, have little (remaining) net worth or economic value. As such, their conversions under the standard model involved only small transfers of economic value (wealth) from non-buying members to buying members and outside investors. As we would expect,

during 1980-1989, when converting thrifts reported very low capital ratios (levels of tangible equity averaging 1.6 percent of assets), first-day pops were correspondingly low (averaging 5.6 percent).³¹ Thus, standard conversions were less inequitable and less troubling when thrifts were undercapitalized.

As figure 1 shows, however, mutual thrifts' capital ratios have increased greatly since then. During 1991-2004, for example, mutual thrifts had high capital ratios (averaging more than 10 percent) and correspondingly large first-day pops (averaging 20.8 percent),³² raising concerns about large transfers of economic value from non-buying members to buying members and outside investors.

Conversions of credit unions and former credit unions

As we have shown, the standard conversion model provides strong incentives for well-informed managers and directors of highly valuable mutual thrifts to push their institutions to convert. Perhaps unsurprisingly, 1,943 mutual thrifts converted since 1975, and the remaining number of mutual thrifts dwindled from 3,791 to about 500 today.³³ As the numbers of mutual thrifts continue to shrink, some consultants and investors who specialize in thrift conversions shifted their attention to credit unions.³⁴ In contrast to mutual thrifts, on December 31, 2010 there were still 7,491 credit unions in the US, with \$927 billion in assets. To date, the total number of credit unions that have converted to mutual thrifts is small, but most converting credit unions subsequently converted to stock thrifts. Moreover, since most converting credit unions were well capitalized, their conversions raise concerns about transfers from non-buying members to insiders and outside investors.

The first credit union conversions involved protracted consultations between a network of consulting firms and law firms and state and federal regulators. For instance, after conversion specialists approached the OTS in 1994, it adopted rules easing the conversion of credit unions to mutual thrifts.³⁵ Since 1970, section 205 of the Federal Credit Union (FCU) Act authorized the National Credit Union Administration (NCUA, the federal regulator for credit unions) to regulate conversions of federally-insured credit unions to non-credit unions.³⁶ Lusitania FCU was the first credit union to convert to a non-credit union, completing its conversion between June 1994 and September 1995.

As Lusitania FCU converted, in June 1994 the NCUA proposed and, in March 1995, adopted its first set of regulations for conversions of credit unions to non-credit unions.³⁷ Under these regulations, for the NCUA to approve a conversion, members had to vote to convert not only by a majority of votes cast, but by the majority of all members. Thus, although the majority of votes cast favored converting Citizens Community FCU in 1997, those votes fell short of the majority of members and the conversion did not take place.³⁸ Nonetheless, even under the stricter voting requirements several credit unions converted in 1998.

40 Following lobbying by conversion specialists³⁹ and unrelated litigation about fields of membership, in 1998 Congress passed the Credit Union

Membership Access Act (CUMAA),⁴⁰ which relaxed the requirements for credit unions to convert to mutual thrifts. The new section 205(b)(2) of the FCU Act relaxed the voting requirements for conversions from the majority of all members to only the majority of votes cast. Thus, four years after its first attempt, Citizens Community FCU converted following a new vote: 7 percent of members voted in favor, 4 percent voted against, and 89 percent did not vote. Since then, fewer than 20 percent of members participate in most conversion votes.⁴¹

Recognizing the potential conflicts between the interests of typical members and those of insiders, the NCUA has, over the years, sought to strengthen its oversight and regulation of credit union conversions. NCUA has come to require additional disclosures and voting protections and has occasionally undertaken litigation. The NCUA's efforts have likely forestalled some conversion attempts. As a result, the total number of credit unions that have converted to thrifts is still relatively small. Thus far, only 26 credit unions have converted to mutual thrifts, six credit unions have merged into mutual thrifts, and three credit unions transformed into stock thrifts wholly-owned by mutual insurers.⁴² No credit unions converted during 2010 and conversion specialists reported that, in 2011, five credit unions were at various stages in their conversions. Nonetheless, during 2011, reports circulated that a number of large, successful credit unions were very interested in converting.

So far, then, converting credit unions account for a small fraction of aggregate credit union assets and, even, of the annual increase in credit union assets. Converting credit unions from 1995 through 2010, including the nine related transactions, totaled \$8.1 billion in assets, which was less than 1 percent of credit union assets as of December 31, 2010. On an annual basis, converting credit unions averaged less than 0.1 percent of credit union assets from 1995 through 2010, or about 1.3 percent of the annual increase in credit union assets. In contrast to mutual thrifts, conversions have had no perceptible effect on the size of the credit union industry.

While the specific paths vary widely, of the twenty-three credit unions that converted to mutual thrifts between 1995 and 2006 (i.e., excluding the six merger conversions, the three related to mutual insurers, and three of the most recent conversions in 2007 and 2009), only two (Carolina FSB and Bank @lantec) have taken no steps toward issuing common stock. Ten have engaged in standard conversions, and one (1st Security Bank of Washington) has filed to do so with the Securities Exchange Commission (SEC). Eight have engaged in "first step" conversions becoming hybrids (i.e., mutual holding companies, MHCs) selling stock to investors, but with the members, as a voting bloc, retaining the majority of the voting power. Of these eight MHCs, seven subsequently engaged in "second step" conversions, abandoning the hybrid format and becoming full stock companies. One (Lusitania SB) has formed a "private MHC," having yet to announce any plans to sell its outstanding stock to investors. And one (Community Schools) first converted to a mutual thrift and later merged with a MHC (Citizens Community), which subsequently engaged in a second step conversion. Of the six credit unions that engaged in

merger conversions, only two (Roper Employees and Northeast Community) remain within entities that are mutual thrifts.⁴³ Thus, most credit unions that convert to mutual thrifts eventually convert to stock thrifts.

Credit unions did not begin to convert to mutual thrifts until well after the thrift crisis and the subsequent overall recapitalization of the depository industry. Thus, converting credit unions have typically had high capital ratios, raising concerns about transfers of economic value from non-buying members to insiders and outside investors. Figure 4 presents first-day pops for the IPOs of former credit unions (column 5), along with their credit union to mutual thrift conversion dates (column 2), the types of conversion IPO they underwent (column 3), and their IPO dates (column 4). The sizes of first-day pops for standard, first-step, and second-step conversions of former credit unions are similar to those of other thrifts that converted around the same times (not shown here). From 1999 through March 2011, first-day pops at former credit unions across standard and first step IPOs⁴⁴ were large, with an average of 19.9 percent and a median of 18.6 percent.

Figure 4: Initial public offerings (IPOs) in former credit unions (1999 – March 2011)

Name of former credit union (1)	Credit union to mutual thrift conversion date (2)	Type of conversion IPO (3)	IPO dates (4)	First-day pop (%) (5)
AWANE FCU	5/1/1996	First step Second step	6/29/2004 6/26/2006	3.8 0.0
BUCS FCU	3/1/1998	Standard	3/15/2001	30.0
Synergy FCU	5/1/1998	First step Second step	9/18/2002 1/21/2004	29.3 9.0
Affiliated FCU	6/1/1998	Standard	6/1/2001	7.5
Ohio Central FCU	6/1/1998	Standard	4/1/2005	20.0
IGA FCU	7/1/1998	Standard	10/5/1999	8.6
Beacon FCU	7/1/1999	Standard	10/2/2007	16.0
Kaiser Permanente FCU	11/1/1999	First step Second step	3/31/2004 11/19/2010	34.9 0.0
Pacific Trust FCU	1/1/2000	Standard	8/23/2002	18.6
Atlantic Coast FCU	11/1/2000	First step Second step	10/5/2004 2/3/2011	17.5 1.0
Rainier Pacific CU	1/1/2001	Standard	10/21/2003	69.9
AGE FCU	7/1/2001	First step Second step	6/30/2005 11/30/2010	7.5 2.5
Allied Pilots Association FCU	9/1/2001	Standard	12/31/2001	19.0
Citizens Community FCU	12/12/2001	First step Second step	3/30/2004 10/31/2006	23.7 4.7
CU of the Pacific	5/19/2003	First step	1/9/2008	-10.0
Share Plus FCU	10/1/2004	Standard	11/1/2010	- 6.0
OmniAmerican CU	1/2/2006	Standard	1/21/2010	18.5
Community CU	1/2/2006	First step Second step	10/3/2006 7/7/2010	49.9 - 5.0

Source: SNL ConversionWatch (multiple issues).

Old and new rules for thrift capital and conversion

The FHLBB advocated the standard conversion model because it would both raise capital and prevent deposits from moving toward thrifts that were expected to soon convert. It achieved those goals. But, the standard conversion model provides the biggest incentives to convert to the strongest (typically the most highly capitalized and economically valuable) thrifts and credit unions. The more capital (or other sources of economic value) that a mutual thrift has, the larger the investors' rewards to converting. Because so few members avail themselves of the offers to buy stock, in practice, the standard model transfers economic value from all members to insiders and outside investors.

The FHLBB and the OTS had, and the NCUA and the OCC have, alternatives. Regulators could have largely achieved their goals with policies that were widely debated since at least the 1970s, including some proposed by the regulators themselves. Government agencies, policymakers, and academics have put forward similar proposals since then. For instance, to reduce the arbitrary wealth transfers that the standard conversion model produces, we have proposed that the NCUA allow credit unions to convert directly to stock-owned commercial banks, while freely distributing shares of stock to members on the basis of their longer-run deposit and loan histories.⁴⁵

Government agencies, policymakers, and academics have also proposed counting suitable nonvoting securities as capital at mutually- and cooperatively-owned depositories.⁴⁶ As already noted, an early example of such proposals was the 1977 GAO report that (1) recommended that Congress extend a moratorium against conversions under the standard model, (2) pointed out that the FDIC permitted savings banks to count subordinated debt as capital, and (3) pointed out that mutual S&Ls could have raised capital if the FHLBB had followed the FDIC's approach.⁴⁷

Just before adopting the standard conversion model, the FHLBB made a last effort to defend the free distribution model in its proposed 1973 regulations.⁴⁸ The FHLBB regulations would have (1) permitted thrifts to distribute their net worth as shares of common stock to members who did not object, (2) required thrifts to distribute their net worth as cash to individual members who so requested, (3) permitted thrifts to sell shares of common stock beyond the amounts that they freely distributed, and (4) required that free distributions taking place after 1977 not be based on deposits as of a single recent date, but be based on a five-year history of deposits.⁴⁹ By ensuring that long-time depositors would get substantially more than recent depositors, the regulations would have greatly weakened the incentives for depositors to move funds toward mutual thrifts that were expected to soon convert.

Interestingly, the FHLBB has not been the only federal regulator to propose conversion regulations that sought to respect members' ownership interests, only to abandon such proposals soon after releasing them. In 1994, the FDIC released an unflinching critique of the standard conversion model and implicitly backed free distribution for the mutual thrifts it regulated.⁵⁰ However, following opposition from the OTS, the FDIC then quickly adopted

the standard conversion model. In 2005, then NCUA Chairman JoAnn Johnson asked Congress to consider the similar demutualization model for credit unions.⁵¹ Former NCUA Chairman Ed Callahan also advocated that dissenting members in a conversion should have the option to cash out their *pro rata* share of retained earnings.⁵² Along the same lines, Massachusetts State Senator Dianne Wilkerson proposed the demutualization model for conversions of Massachusetts-chartered mutual thrifts.⁵³

The free distribution model is, to be sure, not a complete guarantee that no transfers of members' economic value will take place, as shown by the conversion in 2000 of the insurance company John Hancock Financial Services. Upon conversion, its members received a *pro rata* allocation of shares of common stock. But, unless they took action to the contrary, members' shares were sold for cash on the day of the IPO at a management-determined price of \$17 per share. So few took the affirmative action that 75 percent of shares were thus sold. The barrage of sales of shares likely put at least temporary downward pressure on the stock price. Managers, who were not permitted to buy shares until 21 days after the IPO date, may then have been able to buy at lower prices. Within one year, the stock price had increased to \$34.40.⁵⁴

Thus, conversions under both the free distribution and the standard models may convey less than the total economic value of their institutions to members. The key differences are that (1) the transfers involved in standard conversions are not obvious to many observers and (2) the scope for transfers in free distributions is far smaller. In the John Hancock case, the 75 percent of members who accepted cash payments may have forgone some value by accepting \$17 per share instead of the \$34.40 that shares reached one year later. However, had John Hancock engaged in a standard conversion, the 75 percent of members who chose not to hold on to their shares of stock (or probably a larger fraction in line with non-buyers in thrift conversions) would have received payments of \$0 per share, instead of \$17 per share.

Conclusion

Federal regulators encouraged mutual thrifts to convert under the standard model as a way to raise their capital. It achieved that goal. But, when the remaining mutual thrifts accumulated substantial levels of capital, the standard model contributed to the demise of the mutual thrift industry and simultaneously to the predictable transfers of substantial amounts of wealth from typical members to insiders and outside investors. Similar forces are at play now for credit unions. Implementing longstanding, but long-ignored, capital and conversion proposals would open the door for mutual thrifts and credit unions to acquire capital and would close the door on large transfers of wealth from typical members to insiders and outside investors.

NOTES

1. Harris C. Friedman and Donald M. Kaplan, "The Impact of 'Free Distribution' Conversion Windfalls on the Savings and Loan Industry," *Journal of Finance* 30 (1975): 681-687; and Henry Cassidy, "Estimates of the Aggregate Impact of Expected Windfalls for a Portion of the S & L Industry," *Journal of Money, Credit and Banking* 8 (1976): 477-485.
2. Thrifts regulated by the FHLBB and the Office of Thrift Supervision (OTS) raised \$46 billion through conversions during 1972-2010. OTS, *2010 Fact Book: A Statistical Profile of the Thrift Industry* (Washington, DC: 2011), http://www.ots.treas.gov/_files/481166.pdf.
3. Wayne M. Lee, "Conversion of Savings and Loan Associations from Mutual to Stock From: Fairness Forgotten," *The Business Lawyer* 33 (1977): 29-48; Haluk Unal, "Regulatory Misconceptions in Pricing Thrift Conversions: A Closer Look at the Appraisal Process," *Journal of Financial Services Research* 2 (1997): 239-254; and Joseph A. Colantuoni, "Mutual-to-Stock Conversions: Problems with the Pricing of Initial Public Offerings," *FDIC Banking Review* 11 (1998): 1-9, www.fdic.gov/bank/analytical/banking/1999mar/mutual.pdf.
4. Fabio R. Chaddad, "The Economics of Organization Structure Changes: A US Perspective on Demutualization," *Annals of Public and Cooperative Economics* 75 (2004): 575-594; Kevin Davis, "Credit Unions and Demutualisation," *Managerial Finance* 31 (2005): 6-25; and James A. Wilcox, *Credit Union Conversions to Banks: Facts, Incentives, and Reforms* (Madison, WI: Filene Research Institute, 2006).
5. Jeff Heinrich and Russ Kashian, "Credit Union to Mutual Conversion: Do Interest Rates Diverge?" *Contemporary Economic Policy* 26 (2008): 107-117.
6. GAO, *Changing Ownership of Mutual Savings and Loan Associations—An Evaluation*. Report to the Senate Committee on Banking, Housing, and Urban Affairs (Washington, DC: May 26, 1977), <http://archive.gao.gov/f0902c/102138.pdf>. The GAO has since changed its name to the Government Accountability Office.
7. Public Law 73-66. We provide a more detailed description of the history, legislation, and regulation of commercial banks, thrifts, and credit unions in Wilcox, *Credit Union Conversions*.
8. Public Law 72-304.
9. Public Law 111-203.
10. OTS, "Charter and Bylaws; One Member, One Vote," 63 *Federal Register* (FR) 46159 (Washington, D.C., August 31, 1998), <http://www.ots.treas.gov/docs/7/73042.pdf>.
11. See for instance, James R. Barth, *The Great Savings and Loan Debacle* (Washington, DC: American Enterprise Institute, 1991).
12. The economic, regulatory, and accounting definitions of the terms capital, equity, net worth, and reserves are closely linked, but differ in many of their details. For instance, mutuals tend to use the term net worth and stock-owned entities tend to use the term equity. In general, depositories seek to hold large enough cushions of capital to remain in operation should unexpected losses take place. Government policymakers also set minimum regulatory capital requirements to protect depositors, insurance funds, and the functioning of credit and payment systems. The details of capital requirements are complex and vary, both across types of depositories and over time. During troubled economic conditions, the

valuations of depositories' accounting, economic, and regulatory capital may depart markedly. For instance, computations of regulatory capital may place more emphasis on the historical (or book) value of assets with reduced resale values that continue to be performing (i.e., they continue to yield interest). In contrast, potential acquirers computing depositories' economic capital might place more emphasis on current (or market) values.

13. Managers of depositories face ongoing, and unavoidable, tradeoffs regarding asset and liability structures, and profitability and risk profiles. Managers may seek to increase profits, for instance, by holding more higher-rate loans made to borrowers that might be more likely to default or by financing higher-rate, longer-term assets (e.g., home mortgages instead of car loans) with lower-rate, shorter-term liabilities (e.g., 3-month certificates of deposit instead of 5-year certificates of deposit). The credit risk and interest rate risk involved are theoretically straightforward. Depositories reap higher profits if economic conditions turn out to be relatively benign, but could face potentially devastating losses if either loan default rates climb or if interest rates climb significantly. However, selecting the appropriate profit-risk tradeoff at each point in time is easier in theory than in practice. Appropriate asset-liability risk-management cannot meaningfully require avoiding all risks: as in extending credit only to "risk-free" government and government-backed entities, or in matching exactly the average maturities of assets and liabilities. Further, managers living through extended periods of economic stability may become complacent. Managers may make lending decisions assuming that default rates will remain at recent historical levels or, at worst, only reach the average level of recent recessions, rather than set new records. Similarly, managers may assume that interest rates will only fluctuate within the ranges of recent historical norms, rather than set new records.
14. The capital to asset ratio was computed across mutual thrifts insured by the Federal Savings and Loan Insurance Corporation (FSLIC) in 1965-1988 and OTS-regulated thrifts in 1989-2010. FHLBB, *1987 Savings & Home Financing Source Book*, (Washington, DC: 1988). OTS, *1997 Fact Book: A Statistical Profile of the Thrift Industry* (Washington, DC: 1998), and *2010 Fact Book: A Statistical Profile of the Thrift Industry* (Washington, DC: 2011), www.ots.treas.gov/_files/481166.pdf.
15. James A. Wilcox, *Reforming Credit Union Capital Requirements* (Washington, DC: K&L Gates, 3 March 2011).
16. Lee, "Fairness Forgotten."
17. "Mutual-to-Stock Conversions and the Federal Home Loan Bank Board," *The Yale Law Journal*, 82 (1973): 559-572.
18. 12 USC 1461 et seq.
19. These regulations (12 Code of Federal Regulations, CFR, 546.5) were first published in 26 FR 11208, on November 28, 1961.
20. Here, for simplicity, we assume that there is no economic value beyond the book value of net worth. Most businesses, including depositories, would have positive "going concern" value that would raise total economic value above the book value of capital.
21. In 1945-1955, about thirty thrifts converted. In 1961-1962, twenty four thrifts (all but one in Illinois) converted, and eight of those had failed by 1968. Constance R. Dunham, "Mutual-to-Stock Conversion by Thrifts: Implications for Soundness," *New England Economic Review* (January/February 1985): 31-45.

22. Dwight Smith and James Underwood, *Mutual Savings Associations and Conversion to Stock Form* (Washington, DC: OTS, May 1997), www.ots.treas.gov/docs/4/48801.pdf.
23. These regulations (12 CFR 563b) were first proposed in 38 FR 11208, on December 10, 1973 and adopted in 39 FR 9141, on March 7, 1974. A partial, temporary Congressional moratorium introduced in October 1974 expired on June 1976. Dunham, "Implications."
24. Since few members exercise their nontransferable rights to buy stock, their priority right does not have any practical implications, and non-members can, in effect, buy shares in conversions on the same basis as members. Wilcox, "Credit Union Conversions."
25. Appraisals seek to set the amount of stock to be sold based on the net worth and expected earnings of each thrift, and on the current price to earnings and price to book (i.e., equity or net worth) ratios in samples of neighboring stock thrifts and commercial banks. GAO, "Changing Ownership." For a discussion of the conceptual difficulties involved in applying the required appraisal process, see Unal, "Regulatory Misconceptions."
26. As previously mentioned, mutuals tend to use the term net worth and stock-owned entities tend to use the term equity for, roughly, the same economic and accounting concept.
27. FDIC, "Mutual-to-Stock Conversions of State Nonmember Savings Banks: Notice; Request for Comments," 59 FR (Washington, DC: June 13, 1994).
28. FDIC, "Request for Comments."
29. Wilcox, "Credit Union Conversions."
30. Steven R. Cox and Dianne M. Roden, "Initial Public Offerings by Mutual Thrifts: The Regulatory Impact," *Journal of Economics and Finance* 23 (1999): 113-122. Conversion first-day pops, of course, vary in practice. The pops likely depend on many variables, including the pre-existing amount of retained earnings, the size and liquidity of the offering, investors' assessments of the institution's future earnings, and ongoing market-wide price-to-book ratios. See, for instance, James A. Wilcox and Zane Williams, *Predicting Excess Returns with Public and Insider Information: The Case of Thrift Conversions*, Research Program in Finance, Working Paper RPF-283, (Berkeley, CA: University of California at Berkeley, 1998).
31. Kenneth A. Carow, Steven R. Cox, and Dianne M. Roden, "The Role of Insider Influence in Mutual-to-Stock Conversions," *Journal of Money, Credit and Banking* 39 (2007): 1287-1304.
32. Carow et al., "The Role of Insider Influence."
33. The number of mutual thrifts has also decreased through mergers among healthy institutions, liquidations, and mergers of troubled institutions into healthier ones.
34. Eric Luse and John Gorman, "Conversions – A Review of 2004 and the Outlook for 2005," *ThriftINVESTOR* (February 2005) 10-15.
35. Carolyn B. Lieberman, *Legal Opinion Re: Employees Credit Union* (Washington, DC: OTS, 12 January 1994), www.ots.treas.gov/docs/5/56403.pdf. The leading conversion specialists are Alan Theriault, of CU Financial Services, and Richard Garabedian, at the Luse, Gorman, Pomerenk, & Schick, P.C. law firm.

36. In 1934, Congress passed the FCU Act (Public Law 467 – 73rd Congress) introducing the FCU charter. In 1970, Congress amended the FCU Act (Public Law 91-468), charging the NCUA with administering the National Credit Union Share Insurance Fund (NCUSIF) as a federal insurer for shares (i.e., deposits) in credit unions, and also including the FCU Act's first sections pertaining to conversions to non-credit unions.
37. These regulations (12 CFR 708a) were first published in 60 FR 12659, on March 8, 1995.
38. CU Financial Services, "Less than 30 Days to Vote: Conversion Obstacle – Time," *Converting from a Credit Union* (Portland, ME: 15 January 1998).
39. CU Financial Services, *Our Capabilities* (Portland, ME: accessed on 8 June 2005).
40. Public Law 105-219.
41. National Association of Federal Credit Unions (NAFCU), *Credit Union Conversions: NAFCU Policy Recommendations* (Washington, DC, 19 September 2005).
42. For a list of credit union conversions, see: www.cufinancial.com/meetconverted.html.
43. Several of these converted stock thrifts have been subsequently acquired by other stock thrifts or commercial banks (BUCS, Synergy, Ohio Central, and IGA) and one has failed (Rainier Pacific) subsequently being purchased by another bank.
44. First-day pops in second-step conversions are commonly much smaller than in standard and first step conversions, as any expected gains would be incorporated into the price of the stock already-trading from first step conversions.
45. Wilcox, "Credit Union Conversions."
46. Wilcox, "Reforming."
47. GAO also pointed out FHLBB regulations hindering thrifts from issuing subordinated debt. For instance, the FHLBB required a minimum size of \$50,000 for subordinated debt, in effect, closing the market to retail investors. GAO, "Changing Ownership."
48. These regulations were proposed in 38 FR 1334, on January 11, 1973 and would have been codified as 12 CFR 563b.
49. In particular, 30 (25, 20, 15, and 10) percent of distributions would be based on deposits five (four, three, two and one) year(s) before the conversion. As a transitional policy, for conversions before 1977, the historical weighting would have been stretched annually from one to four years.
50. FDIC, "Request for Comments."
51. In the US insurance industry and in the depository industries of other English-speaking countries, the free distribution model is often referred to as demutualization. "NCUA Calls for Return of Member Equity in CU Conversions," *CU Journal*, 14 June 2005.
52. Ed Callahan and Bucky Sebastian, "Conversions Need to Rethink How Equity is Handled," *Callahan's Credit Union Report*, 7 June 2004.
53. Dianne Wilkerson, *Senate Bill No. 662: An Act Relating to Mutual Holding Companies* (Boston, MA: General Court of the Commonwealth of Massachusetts, 2005).
54. David Schiff, "John Hancock's CEO Should Be Fired," *Schiff's Insurance Observer*, 18 July 2003.