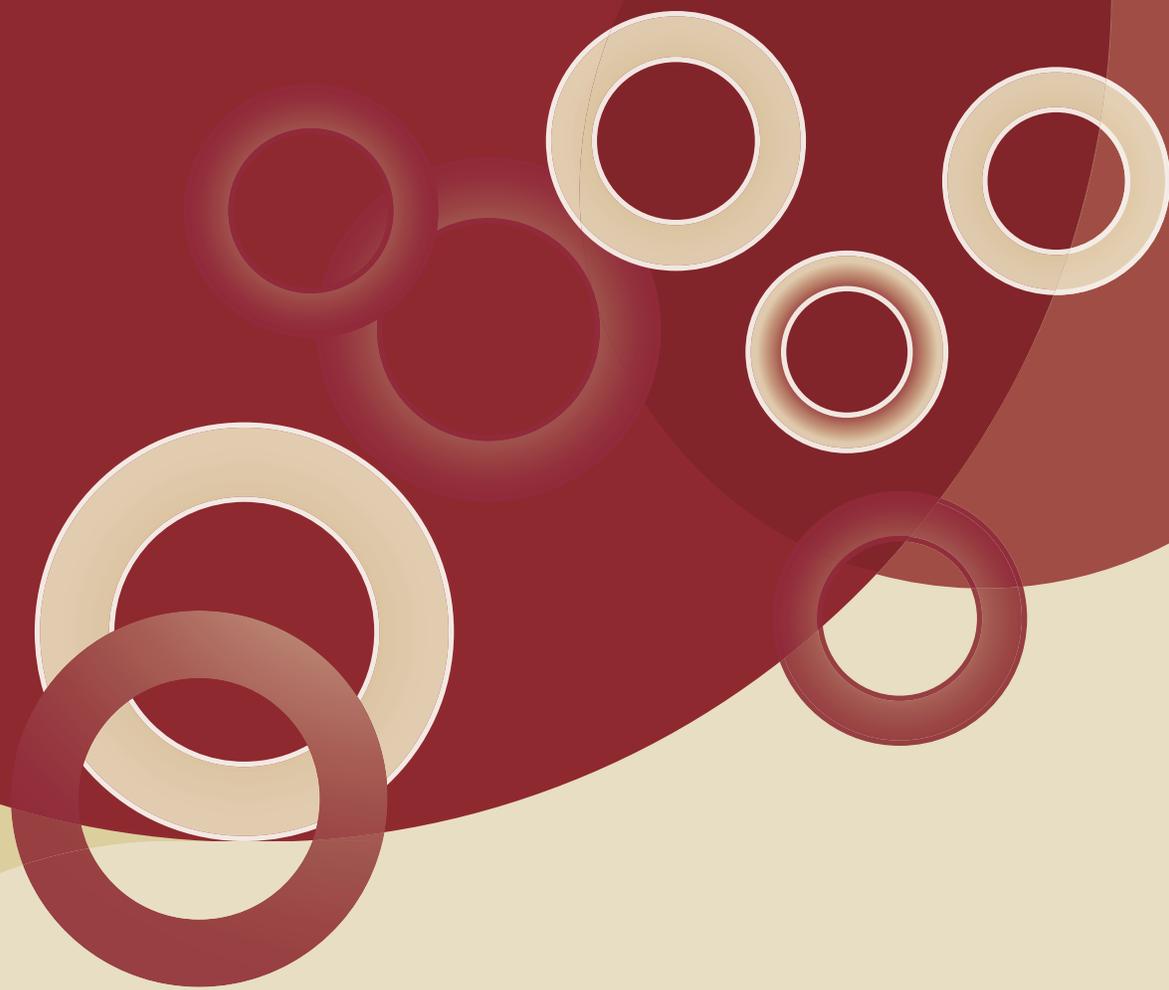


Credit Union Conversions to Banks: Facts, Incentives, Issues and Reforms

JAMES A. WILCOX, HAAS SCHOOL OF BUSINESS,
UNIVERSITY OF CALIFORNIA AT BERKELEY



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RESEARCH INSTITUTE



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Filene Research Institute

The **Filene Research Institute**, is a 501(c)(3), non-profit organization dedicated to scientific and thoughtful analysis about issues affecting the future of consumer finance and credit unions. We support research efforts that will ultimately enhance the well-being of consumers and assist credit unions in adapting to rapidly changing economic, legal, and social environments.

Deeply imbedded in the credit union tradition is an ongoing search for better ways to understand and serve credit union members and the general public. Credit unions, like other democratic institutions, make great progress when they welcome and carefully consider high-quality research, new perspectives, and innovative, sometimes controversial, proposals. Open inquiry, the free flow of ideas, and debate are essential parts of the true democratic process. In this spirit, the Filene Research Institute grants researchers considerable latitude in their studies of high-priority consumer finance issues and encourages them to communicate their findings and recommendations.

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Progress is the constant replacing of the best there is with something still better!

— Edward A. Filene

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Executive Summary and Commentary

by George A. Hofheimer,
Director of Research

In his wildly popular book *The Tipping Point*, Malcolm Gladwell examines the emergence of epidemics. Specifically Gladwell explores why changes in our society happen suddenly and ostensibly without warning. He contends the rapid transformation of ideas, products and diseases from today's unknowns into tomorrow's epidemics require three ingredients: "...one, contagiousness; two, the fact that little causes can have big effects; and three, that change happens not gradually but at one dramatic moment."¹ Credit unions experience the Tipping Point theory through the seemingly overnight materialization of courtesy pay services, name/brand changes, business lending services and community charters. Did you see these trends coming or did they catch you off guard? In a similar vein, this research paper examines credit union to bank conversions. While the absolute number of credit unions converting to banks is miniscule, we need to be mindful that today's weak signals often become tomorrow's trends and business realities.²

From the first credit union-to-mutual thrift conversion in 1995 until 2005, a total of 27 credit unions have either converted to mutual thrifts or merged with mutual thrifts. The total amount of assets involved in these credit union conversions is \$3.1 billion or a mere 0.5 percent of credit union assets. However, assets in credit unions converting in 2006 exceeded \$2.5 billion with the noteworthy conversions of OmniAmerica Credit Union and Community Credit Union both. The ingredients for a credit union tipping point seem to be in place. Who's next? The answer could be a significant number of credit unions in the very near term.

To understand the dynamics at play in the conversion controversy this research study examines past, present and future issues in financial institution chartering with a specific focus on facts, incentives and potential reforms in credit union to bank conversions. The researcher, Jim Wilcox of the University of California at Berkeley, presents a number of key findings and important information to inform policy makers, credit unions and other stakeholders about the credit union to bank conversion story. Specifically:

¹ Gladwell, Malcom (2000) *The Tipping Point*, Little Brown and Company.

² For an excellent discussion on preparing your credit union for weak signals on the periphery we encourage you to read the article by Paul Schoemaker and George Day entitled "Peripheral Vision" in the November 2005 edition of the *Harvard Business Review*.

-
- Savers and borrowers in the United States can choose from a variety of depository institutions that differ by charter. Charters may be either federal or state; they may be for banks, thrifts, or credit unions. Being mutuals, credit unions are cooperatively owned by their members. Credit unions are exempt from corporate income taxes. Credit unions are also more restricted than other depositories in their fields of customers, their investment and lending powers, and their ability to raise capital. Mutual thrifts (including mutual savings banks and mutual savings and loan associations) face fewer restrictions, but are not exempt from corporate income taxes and may convert to stock-owned institutions.
 - Credit union-to-mutual thrift conversions are often a first step toward stock ownership. Of the 17 credit union conversion actions between 1995 and 2002 (excluding merger conversions and more recent conversions), 14 former credit unions have issued some type of stock or have merged with stock-issuing former credit unions. Two additional former credit unions have converted to mutual holding companies that may issue stock without an additional vote by members.
 - Credit union-to-mutual thrift conversions are coming to the forefront, while mutual-to-stock conversions among thrifts are largely coming to an end. Between 1975 and 2004, there were 1,830 mutual-to-stock thrift conversions, and the number of mutual thrifts shrunk from 3,791 to 625. Between 1975 and 2004 credit unions grew from 2.4 to 6.3 percent of assets in all depositories, mutual thrifts shrunk from 23.7 to 1.4 percent, and stock thrifts and commercial banks grew from 73.9 to 92.3 percent.
 - Conversions to the stock form under current OTS and FDIC regulations involve the transfer of claims on the retained earnings of a mutual thrift from members who do not buy stock in initial public offerings to presumably better-informed members and external investors who buy stock. These transfers are reflected in large, first-trading-day increases in the stock prices of converted thrifts and former credit unions.
 - This report uses a straightforward approach to help assess whether members would be likely to benefit from their credit union's conversion to being a stock institution. Members are unlikely to benefit from conversion if their credit union provides moderately better loan and savings rates than their stock competitors do, or

if their credit union is not overcapitalized. Overcapitalized credit unions may avoid becoming conversion targets by distributing excess capital to members, either directly as cash or indirectly by offering even better loan and savings rates.

- Between 1995 and 2004, converting credit unions have, on average, not had substantially higher asset growth rates or substantially lower capital, or net worth, ratios than comparable credit unions that did not convert. During this period, converting credit unions had higher ratios of loans, real estate loans, member business loans, and net loan charge-offs to assets than credit unions that did not convert.
- Mutual insurance companies in the United States and depositories in other countries often use variants of the demutualization model in conversions. Under this model, members do not receive options to purchase shares of stock in an IPO. Instead, they receive actual shares of stock and/or cash payments.
- We present a variant of the demutualization model that the NCUA could implement. Authorizing this variant would not require legislation. The NCUA could permit credit unions to convert directly into (stock) commercial banks. Shares of stock in the bank would be distributed to members in proportion to their historical savings (and/or borrowings). This variant would reduce the transfers from members who, under current OTS and FDIC regulations, do not receive all, and typically do not receive any, of the retained earnings when their mutual thrifts convert.

As you read this well-researched publication you will review historical information, discover new insights and react to the researcher's opinions about future public policy remedies in the credit union to bank conversion debate. The Filene Research Institute is pleased to present a comprehensive analysis of one of the industry's most critical issues. Opinions abound about this controversial topic, and we believe this study presents an unbiased lens of analysis into the facts, incentives, issues, and potential reforms in credit union to bank conversions.

About the Author

James A. Wilcox is the Kruttschnitt Professor of Financial Institutions, Haas School of Business, University of California, Berkeley. Jim is a member of the inaugural group of Filene Research Fellows and a frequent researcher with the Filene Research Institute. From 1999-2001 he served as Chief Economist at the Office of the Comptroller of the Currency. He has also served as senior economist for the President's Council of Economic Advisers, as an economist for the Board of Governors of the Federal Reserve System, and as Chair of the Finance Group at the Haas School. He received his Ph.D. in economics from Northwestern University.

At the Haas School, Professor Wilcox teaches courses on risk management at financial institutions, financial markets and institutions, and business conditions analysis. He has written widely on bank lending, credit markets, real estate markets, monetary policy, and business conditions. His research has addressed reform of deposit insurance, the causes and consequences of the Gramm-Leach-Bliley Act, the effects on bank executives of mergers, the ability of banks to reduce costs following mergers, the differences in bank supervision and regulation around the world, the effects of bank loan losses and capital pressure on lending and small businesses, demographic effects on residential real estate prices, and the efficiencies and credit effects of electronic payments. His articles have been published in leading academic journals, including the *American Economic Review*; *The Journal of Finance*; *The Journal of Economic Perspectives*; *The Journal of Money, Credit, and Banking*; *The Journal of Banking and Finance*; *The Journal of Housing Economics*; and *The Review of Economics and Statistics*.

SECTION I: Introduction

This report analyzes credit unions and their conversions into other depository institutions. We concentrate on conversions from credit unions into mutual thrifts and, subsequently, conversions of those mutual thrifts into stock thrifts. We also briefly mention other conversions such as thrifts converting into commercial banks (or vice versa), stock companies converting into or being acquired by mutual companies, and mutual thrifts converting into credit unions.

The report presents facts about credit unions and conversions. It assesses many of the incentives, issues, and reforms that are related to conversions of credit unions. The report presents the viewpoints of various observers: critics of conversions, credit union regulators, consultants and law firms that advise converting institutions, converting institutions, investment banking firms involved in conversion-related public offerings of stock, state and federal legislative members and staff, and academics.

Section II briefly compares the various depository institution charters available in the United States. Charter types include those for credit unions, thrifts, and commercial banks, each with slightly varying state and federal versions. Charters differ somewhat in their treatment of a number of aspects of depositories: corporate structure, compensation of managers and directors, taxation, restrictions on the field of customers, investment and lending powers, capital requirements and ability to raise capital, and regulators and insurers. Credit unions are cooperatively owned, are exempt from corporate income taxes, operate within restricted (if increasingly liberalized) fields of membership, and typically face more restrictions on their investment and lending powers.

The term “thrifts” includes a variety of institutions and charter names including savings banks, savings and loan associations, and cooperative banks. Thrifts may be either mutually- or stock-owned, are not exempt from corporate income taxes, are not bound by fields of membership or (under the federal charter) by branching restrictions, and typically face fewer restrictions on their investment and lending powers than credit unions. Commercial banks have traditionally operated in the stock form, are not exempt from corporate income taxes, are not bound by fields of membership, still face some (albeit increasingly liberalized) branching restrictions, and typically face the fewest restrictions on their investment and lending powers.

Section III describes the history, legislation, and regulation pertaining to conversions of credit unions and former credit unions into other

depositories. Credit unions may convert into mutual thrifts. Mutual thrifts may convert into stock thrifts or reorganize into mutual holding companies that combine some characteristics of the mutual and stock forms. Mutual holding companies may also subsequently convert into full stock ownership. This section also briefly notes other, less frequent conversions such as those of thrifts into commercial banks, commercial banks into thrifts, stock companies into mutuals, and mutual thrifts into credit unions.

Section IV discusses several issues and incentives in conversions. Section IV A reviews governance issues in mutual and stock companies. Section IV B explores how current regulations and policies allocate the (accumulated) retained earnings of institutions that convert from mutual to stock institutions to various groups of stakeholders in mutuals and to external investors. Section IV C reviews reasons that converting credit unions, conversion specialists, and critics of conversions have given for conversions. Section IV D presents a conceptual approach to help assess whether members are likely to benefit if their credit unions convert. Section IV E presents, compares, and analyzes statistically the financial characteristics of converting credit unions and of samples of comparable, non-converting credit unions. This analysis suggests which credit unions are more likely to convert, and why.

Section V presents and discusses potential reforms of public policies toward conversions. Section V A reviews the potential reforms of conversion policies that focus on voting requirements and their regulatory enforcement. Section V B presents proposals for conversion rights that attempt to account for the contributions made by members to retained earnings. The proposals set forth that conversion rights reflect the history of savings (as well as of borrowing) by individual members. Section V C reviews demutualization in insurance companies and depositories in the US and other countries. This section then discusses variants of demutualization for credit unions and presents in more detail how demutualization could work in practice for members of credit unions. Section VI recaps and concludes the report.

SECTION II: A Brief Comparison Of Depository Institution Charters

This section presents various types of charters across which depository institutions may convert in the United States. The three main types are credit unions, thrifts (including savings banks and savings and loan associations), and commercial banks.³ Some of the characteristics across which depositories differ include their (1) name and historical origins, (2) corporate structure, (3) compensation of managers and directors, (4) corporate income taxation, (5) restrictions on the field of customers, (6) investment and lending powers, (7) capital requirements and ability to raise capital, and (8) regulators and insurers. Some of these differences have narrowed over time due to the interplay of technological and financial innovation and deregulation. Other differences are, however, still notable. For each of these charters, there are also differences across state and federal institutions. In the next sections, for simplicity, we concentrate largely on federal charters. Table 8 in the appendix provides a brief comparison of several characteristics of credit unions, mutual thrifts, stock thrifts, and commercial banks.

A. CREDIT UNIONS

Patterned after similar German and Canadian institutions, credit unions have been in operation in the United States for close to a century. The first credit union in the United States was established on November 24, 1908 in Manchester, New Hampshire under the name of St. Mary's Cooperative Credit Association. In 1934 Congress passed the Federal Credit Union Act (public law 467 c. 750), adding the alternative of a federal credit union charter to the variety of state credit union charters then in existence.

Credit unions are organized as cooperative institutions in which members elect boards of directors on the basis of one-member, one-vote, without reference to the amount of savings or borrowings per member, or to their length of membership. Credit unions start their operations without substantial capital (or retained earnings) and without an issuance of tradable shares of stock. Credit unions accumulate reserves (or retained earnings) over time by not distributing all the revenues received from member-borrowers and from other activities to member-savers as dividends (i.e., interest).

³ Figure 8 in the appendix displays the evolution between 1965 and 2004 of the shares of assets in credit unions, mutual thrifts, stock thrifts, and all thrifts out of all assets in depository institutions (including commercial banks).

Members own the retained earnings of an operating credit union as a group, without a right for individual members to withdraw or sell their *pro rata* share in the retained earnings.⁴ Credit union members may benefit from the existence of credit union retained earnings through several mechanisms. High retained earnings may permit the credit union to (1) expand, extending more loans to existing or new members, (2) charge lower rates on new loans or rebate interest on current ones, (3) pay higher dividend (i.e., interest) rates on member share accounts (i.e., deposits), and (4) provide lower-priced services.

Since credit unions are not stock-owned, the compensation of their managers and directors cannot be linked to the performance of a stock price. Most credit union directors receive no substantive financial compensation (Causey 2004: 8). Section IV A discusses governance issues in credit unions, mutuals, and stock companies in more detail.

Critics of credit unions often note that unlike thrifts and commercial banks, credit unions are exempt from both corporate income taxes and the provisions of the Community Reinvestment Act. The credit union exemption from federal corporate income taxes dates back to public law 75-416, passed by Congress on December 6, 1937. Individual credit union members, however, are subject to personal income taxes on the dividends they receive from credit unions. Some members of Congress have periodically revisited both of these exemptions, but neither exemption currently seems under threat (CU Journal 2005i).

Credit union lending and deposit activities are largely circumscribed to a field of membership defined by a common bond. Historically, federal and state legislation limited fields of membership to small groups such as the employees of a single company or plant. Historically, small size conferred some advantages. These credit unions could rely heavily on sponsor subsidies and volunteer labor. With small numbers of members who knew one another closely, members could pressure one another to maintain low default rates or vouch for one another's loans.

There were, however, also some disadvantages. Credit unions often did not reap economies of scale and had difficulty managing concentrated risk such as the risk of failure of their sponsor.

⁴ Members' rights to the retained earnings of a credit union are based *pro rata* on their deposits in the case of liquidation. Solvent liquidations (whether voluntary or involuntary) are rare (CU Journal 2005d).

Over the last three decades, following changes in regulatory interpretation, court decisions, and legislative change, fields of membership have steadily broadened. Credit unions increasingly serve the employees of entire companies with nationwide operations, rather than those of a single plant. They also serve multiple companies, or have fields of membership that include entire geographic communities (covering as much as several counties). Low-income credit unions and some state credit unions may accept deposits from non-members. Credit unions also manage their concentrated risks by selling and buying participation interests in loans to and from other natural person credit unions, making deposits to or borrowing from corporate credit unions, or sharing some of their lending activities through credit union service organizations (CUSOs) that may be owned jointly by several credit unions.

Credit union investment and lending powers historically were restricted to smaller loans with short maturities, typically for consumer purposes. However, many of these restrictions have been lifted, in particular in connection to deregulatory legislation passed during the late 1970s and early 1980s (including the Depository Institutions Act of 1977, public law 95-22). Currently, credit union portfolios are dominated by residential mortgage-related investments (including first mortgages, second mortgages, home equity lines of credit, and mortgage backed securities) and new and used auto loans. Credit unions may also invest in government-backed securities⁵ and corporate credit unions.

There are several restrictions on credit union activities that do not apply to thrifts. Since credit unions are restricted to lending only to members, they may not lend to corporations or purchase corporate bonds. Business lending to members is typically capped at 12.25 percent of assets.⁶ Loan maturity is generally capped at 12 years except for owner-occupied one-to-four family residences.

Following passage of the Credit Union Membership Access Act in 1998, credit unions are subject to net worth (capital) requirements. In general, credit unions are classified as well capitalized if they have a ratio of retained earnings (net worth) to assets of at least seven percent.

⁵ Credit unions were permitted to hold Sallie Mae (i.e., student loan-related) debt until the agency's recent full privatization. Following its privatization, credit unions were required to sell this debt.

⁶ Restrictions on credit union investment and lending powers vary across states for state credit unions. For instance, Vermont first allowed member business lending in 2005 (CU Journal 2005c).

Credit unions are classified as adequately capitalized if that ratio falls to between six and seven percent. At lower capital ratios, credit unions face increased restrictions on their activities and eventually closure. There are special provisions for the capital requirements of new credit unions (under 10 years old), low-income credit unions, and credit unions with riskier portfolios of assets. Since credit unions may, in general, only use retained earnings to meet their net worth requirements, these requirements may require credit unions either to restrict their growth and/or charge (pay) higher (lower) rates on loans (savings) (see Wilcox 2002 for a detailed presentation of credit union net worth requirements and their potential effects).

Federal credit unions are regulated by the National Credit Union Administration (NCUA) and insured by the National Credit Union Share Insurance Fund (NCUSIF) operated by the NCUA. State credit unions are regulated by state regulators. Currently, most state credit unions are required to be insured by the NCUSIF, but some states permit credit unions to insure their members' savings through state-approved private insurers (see Wilcox 2005).

B. THRIFTS

The term thrifts (or savings institutions) includes a broad category of institutions and charters that have historically operated under a wide variety of names including savings banks, building and loan associations, homestead associations, savings associations (or savings and loan associations), and cooperative banks (OTS 2005: 78).

The historical origins and functions of savings banks are quite different from those of commercial banks. Patterned after similar philanthropic institutions in Britain, wealthy, public-spirited individuals launched the first savings banks, contributed start up capital, served as trustees, and managed them conservatively. These institutions sought to promote thrift among the poor and working classes by providing a safe place where small savers, then shunned by commercial banks, could deposit money and earn interest. The earliest savings banks in the United States were the Philadelphia Savings Fund Society, located in Philadelphia, Pennsylvania, and the Provident Institution for Savings, located in Boston, Massachusetts. Both institutions were founded in 1816. State savings bank charters eventually became available in 19 states, but they remain concentrated in the Northeast. Historically, savings banks have had broader lending and investment powers than savings associations, including not only mortgages but also government and corporate

bonds and blue chip common and preferred stocks (Eccles and O’Keefe 1995: 2, FDIC 1997: 211-3, and ACB 2005: 2).

The historical origins of savings associations (or savings and loan associations) in the United States are mutual associations patterned after British building and loan societies. The first savings association in the United States was the Oxford Provident Building Association of Philadelphia County, established in 1831. At the time, commercial banks did not engage in home mortgage lending largely because long-term loans were deemed too risky. The earliest savings associations were characterized by complete mutuality, with all members having roughly equal obligations and rights. The associations required all members to abide by a plan of periodic deposits and pooled those funds to finance the construction or purchase of homes for all members. The order in which funds were provided to members was determined by lottery, and members paid interest on receipt of their loan in addition to their required deposits. The associations did not accept deposits or funds from any other sources and terminated once all members had paid off their loans (Eccles and O’Keefe 1995: 2, Smith and Underwood 1997: 5-8, and SNL 1999: 4).

Within the first one hundred years of their existence, most elements of complete mutuality in savings associations disappeared. Rather than terminate, some associations launched and operated multiple individually-terminating pools of home borrowers. Eventually savings associations did not operate separate pools and de-linked deposits from loans. Members could make deposits without having to borrow or could borrow funds without having to make deposits, simply paying off their interest and principal. Unlike savings banks, savings associations expanded throughout the entire country (Eccles and O’Keefe 1995: 2, Smith and Underwood 1997: 5-8, and SNL 1999: 4).

Well into the twentieth century, nearly all savings banks and savings associations were state-chartered and organized in the mutual form. However, in 1933 Congress passed the Home Owners’ Loan Act (HOLA) establishing the Federal Home Loan Bank Board (FHLBB) and authorizing it to charter federal savings associations. Since there were almost no stock savings associations at the time, the federal charter was in the mutual form. Also, in 1978, Congress passed the Financial Institutions Regulatory and Interest Rate Control Act allowing state savings banks to convert to federal charters (Eccles and O’Keefe 1995: 2 and Smith and Underwood 1997: 14).

In the standard federal mutual thrift charter, members elect their directors. Voting rights are vaguely linked to member deposits, with members receiving one additional vote for each \$100 in excess of their first \$100. Individual charters traditionally capped the maximum number of votes per member between 50 and 1,000 votes (Smith and Underwood 1997: 4). However, in 1998 the Office of Thrift Supervision (OTS, the regulator that replaced the FHLBB, see below) permitted thrifts to cap the number of votes per member at one, to allow converting credit unions (and other thrifts) to operate with one-member, one-vote voting structures (OTS 1998).⁷ Some thrift charters also grant voting rights to their borrowers (OTS 2005: 77).

In contrast to federal mutual thrifts and reflecting their philanthropic origins, many state mutual savings banks do not grant any voting rights to members, but to boards of trustees or corporators. The institutions are managed on behalf of members who benefit from the institutions' lending and revenues, but have no formal influence on the institution (FDIC 1997: 212 and Luse and Gorman 2005: 14).

The development of stock savings associations lagged that of mutuals by over a century. Some states began to authorize stock associations in the 1930s and their geographic expansion was, at first, slow. The number of states permitting stock thrifts grew to three by 1948 and twenty-two by 1974 (Fleck and Stewart 1984, SNL 1999: 4, and Silver 2000: 4). In 1974 Congress first permitted federal stock savings associations, granting them the same investment and lending powers as those of federal mutual savings associations (Smith and Underwood 1997: 4 and 25).

Unlike federal credit unions, thrifts may compensate their directors financially. However, since mutual thrifts have no stock outstanding, they may not base the compensation of managers, employees, and directors on the performance of any stock price. In contrast, stock thrifts commonly use stock options and grants of stock as compensation (KBW 2001: 91). Section IV A discusses governance issues in mutual and stock institutions in further detail.

Since mutual thrifts lost their federal exemption in 1952, both mutual and stock thrifts are subject to corporate income taxes (ACB 2005). Between 1952 and 1996, thrifts lost a number of tax deductions,

⁷ Some former credit unions retain the one-member, one-vote structure after converting (CUNA 2001).

increasing their tax liabilities. Since 1996, thrifts and commercial banks are broadly taxed in a similar fashion. Unlike credit union member-owners, thrift (and commercial bank) stockholders are potentially subject to double taxation of income, once at the corporate level and again on the receipt of dividends or upon capital gains on the sale of stock. The degree of double taxation may be shrinking as (1) larger shares of stock are held within tax-advantaged investment accounts, (2) more stock institutions reorganize as tax-advantaged subchapter S corporations, and (3) some dividends and capital gains are taxed at most at the 15 percent rate rather than at each person's individual marginal tax rate.

Unlike credit unions, all federally-insured thrifts are subject to the provisions of the Community Reinvestment Act (CRA) and thus must meet the credit needs of their entire community, including low and moderate-income neighborhoods. The Act does not provide specific lending requirements, but regulators may take each institution's CRA rating into account when reviewing merger and branching applications (Silver 1997a).

Despite their diverse origins, the differences between the actual balance sheets and the powers available to savings banks and savings associations have grown increasingly blurred in response to both economic and legislative changes over the last three decades. For instance, despite their broader lending powers, savings banks shifted into mortgage lending after World War II. By the 1970s, mortgage lending accounted for two-thirds of savings bank assets and four-fifths of savings association assets, but only one-seventh of commercial bank assets (Eccles and O'Keefe 1995: 2 and FDIC 1997: 213).

The high inflation and interest rates of the late 1970s and early 1980s led to a severe asset/liability mismatch in an industry dominated by long-term fixed-rate mortgage loans. As capital ratios in thrifts plummeted, Congress and state legislatures passed a variety of measures to limit expected heavy losses. These measures included lifting interest rate ceilings and expanding the investment, lending, and deposit-taking powers of thrifts (Eccles and O'Keefe 1995: 3 and FDIC 1997: 219). In addition, in 1982 Congress amended HOLA, merging the federal savings bank and savings association charters into one, thus removing all differences in powers between the two federal charters, and authorizing federal thrifts to adopt (or change to) either name (OTS 2005: 78).

In general, thrifts have broader powers than credit unions. Unlike credit unions, thrifts are not subject to fields of membership and, thus, may accept deposits from and make loans to any individual or corporation. Thrifts also have greater flexibility to form holding companies and subsidiaries that may engage in both traditional banking activities and some non-banking activities including securities brokerage, insurance agency, and real estate investment. Moreover, subject to having a satisfactory CRA rating and passing either the qualified thrift lender (QTL) test or the domestic building and loan association test, federal thrifts may open new branches, merge with credit unions, and acquire existing thrifts or branches nationwide (Luse 1997a: 3, Silver 1997a, KBW 2004: 81, and Ryan Beck 2004: 106).

The QTL test requires federal thrifts to maintain the ratio of qualified thrift investments to portfolio assets above 65 percent. Qualified thrift investments include residential mortgages, mortgage-backed securities, educational loans, small business loans, credit card loans, and consumer loans. Portfolio assets are defined as gross assets minus liquid assets (cash and short-term securities) and properties used in the ordinary conduct of the business of receiving deposits and making loans.⁸ The domestic building and loan association test requires a smaller percentage in a set of qualified investments that is slightly more closely related to building activities (Silver 1997a and Ryan Beck 2004: 106, 110-111).

Some of the federal thrift investment and lending powers that are unavailable to credit unions are, nonetheless, subject to a series of caps. For instance the total of investment-grade commercial paper, investment-grade corporate debt, and consumer loans may not exceed 35 percent of total assets. The total of commercial lending may not exceed 20 percent and commercial lending that does not qualify as small business lending may not exceed 10 percent of total assets. Also, commercial real estate lending may not exceed 400 percent of the thrift's capital (KBW 2004: 81, Silver 1997a, and Ryan Beck 2004: 106).

Thrift capital requirements are broadly similar to bank capital requirements and are typically considered to be less strenuous than those applied to credit unions (KBW 2004: 81, for a more detailed presentation of credit union and bank capital requirements see Wilcox 2002, 2003). To be classified as adequately capitalized, thrifts must

⁸ Calculating the QTL test, consumer loans and small business loans are each capped at 20 percent of portfolio assets. Also, in the calculation of the QTL test, portfolio assets may not fall short of 80 percent of total assets.

maintain a ratio of core capital (retained earnings, common stock, some preferred stock, etc.) to total assets of at least four percent, a ratio of core capital to risk-adjusted assets of at least four percent, and a ratio of total capital (core capital, allowances for loan losses, subordinated debt, other debt-equity hybrids, etc.) to risk-adjusted capital of at least eight percent. To be well capitalized, these three ratios must be maintained at no less than five, six, and ten percent respectively (Silver 1997a). Unlike most credit unions, mutual thrifts may issue securities, such as subordinated debt, to meet their capital requirements (KBW 2001: 68). Stock thrifts may, in addition, issue common stock to meet their capital requirements.

Until the savings and loan crisis of the 1980s, most savings associations (both state and federal) were regulated by the FHLBB and insured by the Federal Savings and Loan Insurance Corporation (FSLIC). On August 8, 1989 Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) abolishing the FHLBB and the FSLIC and creating the Office of Thrift Supervision (OTS) to replace the FHLBB. The Federal Deposit Insurance Corporation (FDIC) was required to launch a separate Savings Association Insurance Fund (SAIF) to insure institutions formerly insured by the FSLIC (OTS 2005: 69 and 78).

The FDIC is the main federal regulator and insurer for state savings banks. Upon the enactment of FIRREA, FDIC insurance of commercial and state savings banks was reorganized under the Bank Insurance Fund (BIF) to be operated by the FDIC. No private or state-sponsored thrift insurer survived the savings and loan crisis, and almost all thrifts are now insured by the BIF or the SAIF of the FDIC. Whereas insurance fees were initially higher for the SAIF, they are currently set at the same level for both insurance funds. And while some thrifts switch from the state savings bank charter to the federal thrift charter (or vice versa), thrifts typically do not switch insurance funds.

C. COMMERCIAL BANKS

The Bank of North America, chartered by the Continental Congress in 1781, is commonly considered the first full commercial bank in the United States. The current template under which investors may launch banks without requiring a specific legislative act dates back to 1838 when the state of New York passed the Free Banking Act. In 1863 Congress broadly followed the same template, passing the

National Bank Act and authorizing the Office of the Comptroller of the Currency (OCC) to charter national banks.

The corporate structure, compensation of managers and directors, taxation, requirements under the Community Reinvestment Act, capital requirements, and ability to raise capital of commercial banks are broadly similar to those of stock thrifts. The main differences between stock thrifts and commercial banks center on their investment and lending powers and their abilities to operate nationwide. Commercial banks are not subject to the QTL test and are subject to far fewer and less strict restrictions on the amounts and types of securities and loans they may hold and make. For instance, commercial banks may hold non-investment grade corporate securities.

Like thrifts, commercial banks are not subject to fields of membership and may accept deposits and make loans to any individual or corporation. However, commercial banking organizations face slightly stricter restrictions on their ability to expand geographically. Under the interstate banking provisions of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, bank holding companies may acquire existing commercial banks across state borders and commercial banks may merge across state borders. Under the interstate branching provisions in the Act, 26 states permit out-of-state commercial banks to acquire existing branches in their state, and 18 states permit out-of-state commercial banks to open new branches in their state (CSBS 2002).

National (i.e., federal) banks are regulated primarily by the OCC. State commercial banks that are members of the Federal Reserve System (Fed) have the Fed as their primary federal regulator. State commercial banks that are not members of the Fed have the FDIC as their primary federal regulator. Both national and state commercial banks are currently insured by the Bank Insurance Fund (BIF) operated by the FDIC.

SECTION III: History, Legislation, And Regulation Of Conversions

This section reviews the history of conversions across depository institution charters and related legislation and regulation. Section III A presents conversions of credit unions into mutual thrifts. Section III B presents conversions of mutual thrifts into stock thrifts. Section III C presents the reorganization of mutual thrifts into mutual holding companies, their subsequent issuance of minority stock, and their conversion into full-stock thrifts. Section III D briefly presents other related (and in some cases rare) conversions of depository institutions such as from stock thrifts into commercial banks, from commercial banks into stock thrifts, from the stock form into mutuals, and from mutual thrifts into credit unions. Conversions of insurance companies in the US and building societies in Britain from the mutual to the stock form are also discussed in section V C.

A. FROM CREDIT UNIONS TO MUTUAL THRIFTS

Lusitania FCU was the first credit union to convert into a non-credit union charter. Its Board of Directors formally adopted a conversion plan on June 25, 1994 and completed its conversion on September 1, 1995 (Kane and Hendershott 1996: 1310). The conversion took place under the provisions of section 205 of the Federal Credit Union (FCU) Act, as amended on October 19, 1970 by public law 91-468 to add a Title II on share insurance. The amended Act (1) required NCUA's approval of conversions of NCUSIF-insured credit unions into charters not insured by the NCUSIF and (2) granted the NCUA broad authority to regulate these conversions (CUNA 2003). This authority covered conversions into uninsured credit unions, credit unions with private or state-sponsored insurers, and non-credit unions. However, since the NCUA had only dealt with a small number of credit unions foregoing federal insurance for private or state-sponsored insurance, the NCUA had yet to develop a detailed regulatory framework for conversions into non-credit union charters.

Credit union conversions are typically assisted by a network of consulting firms and law firms. Alan Theriault, president of the CU Financial Services consulting firm in Portland, Maine, and Richard Garabedian, currently at the Luse, Gorman, Pomerenk, & Schick, P.C. law firm in Washington, D.C., were involved in many of the earliest credit union conversions and remain among the leading conversion specialists (Theriault 2000a: 2 and Reosti 2002). The first conversions involved protracted consultations with various state and federal regulators. For instance, having been approached by conversion

specialists, the OTS adopted rules easing the conversion of credit unions into mutual thrifts in August 1994 (Lieberman 1994 and Kane and Hendershott 1996: 1310).

The first conversions also involved relatively complex legal steps, with credit unions setting up de novo federal mutual thrifts and combining with them through a purchase and assumption (P&A) transaction. The requirement to set up de novo charters and engage in a P&A was later lifted, permitting direct conversions and reducing the notice requirements and time needed for a conversion (Lieberman 1994: 2 and Luse 1997c). According to several conversion specialists, barring unforeseen circumstances, a conversion from credit union to mutual thrift requires between six to nine months (Silver 1997b, Malizia 1998, and Ryan Beck 2005).

As the conversion of Lusitania FCU took place, the NCUA exercised its broad authority under the FCU Act to provide a detailed regulatory framework for subsequent conversions into non-credit union charters. The NCUA proposed new rules on June 30, 1994, adopted an interim rule on September 23, 1994, and a final rule on March 1, 1995. The rules continued to require NCUA's approval of conversions, but added the requirement of an affirmative vote of the majority of all members. Thus, votes not cast were equivalent to votes cast against conversion. This requirement is similar to the current one for mutual-to-stock federal thrift conversions (see section III B). The rules also required credit unions to clear with the NCUA the details of conversion plans and the voting package sent to members (Kane and Hendershott 1996: 1310).

The new rules prevented some conversions. For instance, when Citizens Community FCU held a vote on July of 1997, the majority of voters endorsed conversion, but that majority did not reach 50 percent of members (CU Financial 1998: 2). However, several conversions (five in 1998) did take place under the more stringent voting requirements.

Following lobbying by conversion specialists, federal legislation soon relaxed the requirements for credit union conversions (CU Financial 2005). On August 7, 1998, the Credit Union Membership Access Act (CUMAA, public law 105-219, also commonly known as HR 1151) further amended the FCU Act. Whereas the impetus for CUMAA was a Supreme Court decision regarding fields of membership, the Act affected many other aspects of the operation, insurance, and regulation of federally-insured credit unions (FICUs). For instance, CUMAA introduced net worth requirements for FICUs and changed

the requirements for the ratio of equity held in NCUSIF relative to insured credit union savings (Wilcox 2002, 2003, and 2005).

The new section 205(b)(2) of the FCU Act, as amended by CUMAA, permits FICUs to convert into mutual thrifts without the prior approval of the NCUA. Instead the Act requires (1) the majority of directors to vote for conversion, (2) the credit union to notify its members 90, 60, and 30 days prior to the member vote on conversion, and (3) the affirmative vote of 50 percent of member votes cast (i.e., not the majority of members). The Act also permits the NCUA (4) to require the credit union to inform it of its conversion plans and (5) to oversee the member vote and to reorder a vote if it disagrees with the vote's methods or procedures. The Act also states (6) that directors and managers may not receive economic benefits in connection with the conversion, (7) that the terms of the Act (and by extension NCUA regulations) do not apply to former credit unions once converted into mutual thrifts, and (8) that NCUA rules regarding conversion should be no more or less restrictive than those applicable to charter conversions for financial institutions regulated by other federal regulators.

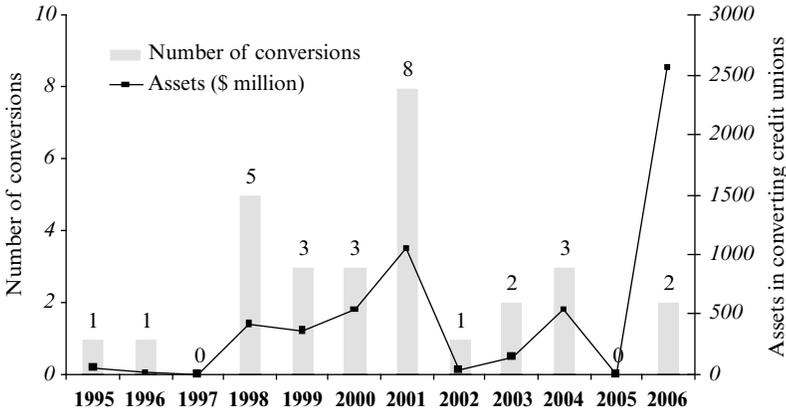
Under the new legislation, credit unions that had failed to obtain affirmative votes by 50 percent of all members attempted to convert again. For instance four years after its first attempt, Citizens Community FCU converted following a new vote, with seven percent of members voting in favor, four percent voting against, and 89 percent not participating. Other recent conversion attempts also received affirmative majorities of voters, but not of members. For instance, in the conversion vote for Sunshine State Credit Union, 11 percent of members voted in favor, seven percent voted against and 82 percent did not participate. In the conversion vote for Community Credit Union, 15 percent of members voted in favor, six percent voted against and 79 percent did not participate (CUNA 2004 and CU Journal 2005). Conversion specialists argue that typical turnouts in conversion votes are under 20 percent of members and that while opposition to conversions is often vocal, it accounts for a small percent of members. Some conversion specialists also recommend various techniques to increase voter turnout such as hiring experienced proxy solicitors and financial incentives such as recent drawings for Cadillac leases or thousand dollar prizes (Malizia 1998 and Wood TV 2004).

Figure 1 displays the recent evolution of the annual number of conversions from credit union to mutual thrift charters and the total asset sizes of converting credit unions from 1995 through January

2006. Since credit unions may also forego their charter by merging with existing mutual thrifts, we include the six cases of these merger conversions in both of our series. On December 4, 2000, Caney Fork Cooperative Credit Union was the first credit union to merge with a thrift (Beacon Federal). Beacon Federal itself was a former credit union that converted on July 1, 1999. Table 9 in the appendix lists all conversions of credit unions into mutual thrifts from 1995 through January 2006, along with their state, asset size on the December 31 prior to conversion, and the dates of conversion.

Figure 1 shows that, from 1995 through January 2006, there were 29 conversions from credit unions to mutual thrift charters (including six mergers of credit unions with thrifts). Thus, the number of conversions per year has been small and in line with the NCUA’s current estimate of no more than five conversions per year (NCUA 2005: 9). The total amount of assets in converting credit unions has been \$ 5,712 million. Up to this point, credit union conversions account for a small fraction of both credit union assets and of growth in credit union assets. The average annual amount of assets involved in conversions from 1995 through January 2006 was less than 0.1 percent of credit union assets and is equivalent to about 1.2 percent of the growth in credit union assets. The cumulative amount of assets in converted credit unions from 1995 through January 2006 is equivalent to about 0.8 percent of credit union assets on December 31, 2004.

Figure 1: Number of credit union conversions and total assets of converting credit unions (1995-January 2006)



Source: CU Financial (2005) and NCUA.
 Note: This figure includes both credit unions converting into mutual thrifts and credit unions merging with (being acquired by) mutual thrifts. Asset sizes are those as of the December 31 prior to each conversion.

However, the annual amount of assets involved in credit union conversions may be trending up significantly. The average asset size of converting credit unions between 1995 and 2005 was little over \$100 million and the largest to convert had been Rainier Pacific, with \$383 million in assets. In contrast, each of the credit unions whose conversions were finalized on January 2006 (Community Credit Union and OmniAmerican Credit Union) held over \$1 billion in assets.

The NCUA argues that, while it fully supports credit unions' right to convert, members cannot exercise that right meaningfully if their credit union provides them with information that is inaccurate and misleading. According to the NCUA, since the effects of conversions on member ownership interests may not surface for a number of years, these effects may not be apparent at the time of conversion to even "the most astute members." Thus, the NCUA has released additional regulations (final rules dated February 25, 2004 and January 13, 2005, included in NCUA Rules and Regulations, Part 708a (Chapter VII, Title 12 of the Code of Federal Regulations) requiring converting credit unions (1) to provide their members with a series of additional disclosures and (2) to use certain voting procedures in conversions (NCUA 2005: 1-3 and 6).

In particular, these regulations require (1) conversion votes to be conducted by secret ballot by an independent entity with experience in conducting corporate elections, (2) a disclosure of whether and/or how voting rights will change, (3) a disclosure that members could lose ownership interests in a subsequent conversion to a stock institution if the members do not purchase stock, and (4) a disclosure of whether the credit union intends to convert into a stock institution and increase compensation for directors and managers, including stock-related benefits. The regulations also require credit unions to send their members a standardized boxed disclosure drafted by the NCUA stating (5) that members with larger balances in mutual thrifts may have more control, (6) that mutual thrifts compensate their directors and pay corporate income taxes potentially leading to higher loan rates, lower savings rates, and higher fees for services, (7) that executives obtain more stock than regular members in subsequent mutual-to-stock conversions, and (8) estimates of the costs of conversion broken down across several categories.

The reactions from various trade associations to these additional regulations are not surprising. The Credit Union National Association (CUNA) and other credit union leaders have supported the regulations as additional transparency and disclosure appropriate to the post-Enron

era (CUNA 2003). The American Bankers Association (ABA) and conversion specialists denounce the regulations as NCUA efforts to make conversions more costly and difficult and, thus, to keep its regulatees captive. The ABA also argues that these conversions are mutual-to-mutual transactions and not necessarily the first step in a march to the stock form (Causey 2004: 3 and Luse and Gorman 2005: 10).

Examples of estimates of costs in recent conversion attempts include \$1 million for Columbia Community Credit Union (an institution located in Washington State and with \$619 million in assets on the December 31 prior to its conversion attempt), \$700,000 million for Lake Michigan Credit Union (\$1,148 million in assets), and \$906,000 for OmniAmerican Credit Union (\$1,160 million in assets). For instance, part of the breakdown of expenses for OmniAmerican Credit Union was: legal fees and expenses (\$200,000), consulting expenses (\$170,000), a membership awareness campaign (\$123,000), postage for mail disclosures and ballots (\$117,000), and mailing (\$115,000) (CU Journal 2004b and 2005c).

NCUA regulations (Part 708a.5 (b)(2)) also permit states to have legislation and regulations that impose more stringent requirements for the conversion of federally-insured state credit unions. Some states (e.g., Massachusetts) do not permit their state credit unions to convert into mutual thrifts (CU Journal 2005a). Some states (21 according to interviews with NCUA personnel) explicitly permit credit unions to convert. Other states may permit conversions through parity provisions.

Some states permit conversions, but set higher thresholds than 50 percent of voting members in their conversion votes. For instance, 60 percent of members voting endorsed the conversion of Lake Michigan Credit Union, but the conversion fell short of the state statutory requirement of two thirds of voting members (CU Journal 2004c). Theoretically, state credit unions not permitted to convert or facing higher state requirements could convert into federal credit unions as an intermediate step. However, this process might require the credit union to lose parts of its field of membership (or not to accept new members from those parts) and to forego the ability to provide certain loans and services not permitted to federal credit unions.

B. FROM MUTUAL THRIFTS TO STOCK THRIFTS

Over the past few decades, Congress and individual states have broadened the ability of thrifts to operate in either the mutual or stock form. In 1948, Congress first permitted federal mutual savings associations to convert into state stock savings associations. With the passage of public law 93-495 in 1974, Congress permitted (1) the FHLBB (and later the OTS) to charter federal stock savings associations and (2) federal mutual savings associations to convert into the stock form. Since passage of the Garn-St. Germain Depository Institutions Act in 1982, both savings associations and savings banks may obtain a federal stock or mutual charter without regard to their previous status (Smith and Underwood 1997: 24-25, SNL 1999: 4, and Silver 2002: 2-4). Further, Congress has granted the FHLBB (and later the OTS) broad authority to regulate mutual-to-stock conversions of federally-regulated thrifts (OTS 1994a: 1). The dates in which various states first permitted mutual savings banks to convert into the stock form include 1969 (New Hampshire), 1975 (Maine), 1981 (Vermont), 1983 (Connecticut, Oregon, and Rhode Island), and 1985 (Massachusetts) (Eccles and O'Keefe 1995: 3).

Federal regulations of mutual-to-stock thrift conversions before 1974 were based on the "free distribution model" under which members received a *pro rata* share of the retained earnings of the mutual institution in the form of either stock or cash based on their deposits. However, these conversions were often surrounded by controversy. Several studies and congressional hearings highlighted a variety of concerns. These concerns include (1) that recent withdrawers would get nothing, recent depositors would get the same as long-time depositors, and that "professional depositors" would open accounts to cash in free distributions, (2) that members and professional depositors would pressure thrifts to convert to receive windfalls, (3) that members would sell their stock quickly for an easy profit and that insiders with better information could then acquire stock at low prices, (4) that conversions would thus be initiated and manipulated by managers and directors to benefit at the expense of uninformed members, (5) that conversions under the free distribution model would not attract additional capital into thrifts, (6) that conversions would be most common among marginal institutions that would inevitably fail, and (7) that free distributions would constitute taxable events for members (Fleck and Stewart 1984: 2, Smith and Underwood 1997: 25-27, and ACB 2003: 3).

These concerns led to periodic regulatory and congressional moratoria on conversions until the FHLBB on March 7, 1974 adopted regulations (included in 39 Federal Register 9141) that abandoned the free distribution model. Under the new regulations, converting institutions do not exchange members' ownership interest for shares of stock, but for nontransferable rights to subscribe to (i.e., buy) stock on a priority basis. Under this approach, the institution would not distribute any of its retained earnings as cash and would raise additional capital (OTS 1994a: 3-7 and Smith and Underwood 1997: 28-29).

With small, periodic amendments, these regulations have provided the framework for the so-called "standard conversion method." In their current form, OTS regulations include several requirements for a conversion to take place. Fifty percent of eligible votes (not of votes cast) must approve the conversion. The vote must be held on or soon after the closing of the subscription offering (see below) with eligibility to vote based on membership as of a voting record date, typically 10-60 days before the vote. Also, management may not use previously obtained "running" proxies for conversion votes, but must request a specific proxy for the conversion vote (OTS 1994a: 3-7, Smith and Underwood 1997: 29, SNL 1999: 6, and KBW 2004: 13).

OTS regulations also require that for the conversion to take place, members (and/or external investors) must buy the minimum amount of shares on sale. The number of shares to be sold is set as a narrow range above and below the fair market value of the institution, as estimated by an independent appraisal in accordance to OTS guidelines. All shares are sold at the same price, typically \$10, but the conversion plan may set a minimum purchase amount, typically \$250. The right to subscribe to (i.e., buy) shares of stock takes place broadly under the following ranking of rights (from first to last right to buy): members as of an eligibility date; the Employee Stock Ownership Plan (ESOP); members as of a supplemental date; other members and borrowers; local residents; and external investors that are not local residents (OTS 1994b: 14, Luse 1997a: 8, SNL 1999: 6-7, and KBW 2001: 44-45).

As a protection for long-time depositors, the eligibility date must be at least one year before the formal adoption of the conversion plan by the Board of Directors. Dates 15-18 months prior are standard. The supplemental date is the last day of the quarter before regulatory approval. The OTS authorizes, rather than requires, thrifts to conduct a direct community offering open to local residents only, before they conduct an underwritten public offering. In practice, all offerings are

held simultaneously, but orders for each class of investor are fulfilled (and the cash accepted) only after all orders in the previous class have been fulfilled (OTS 1994b: 14, Luse 1997a: 8, SNL 1999: 6-7, and KBW 2001: 44-45).

To prevent other potential abuses, OTS regulations also set a number of caps on purchases, sales, and distributions of stock surrounding the conversion. During the initial subscription, the OTS (1) permits thrifts to cap individual purchases of stock (and those of groups acting in concert) to amounts as small as one percent of stock and (2) broadly forbids individual (and group) purchases above five percent. A separate cap of ten percent applies to the ESOP. Managers and directors as a group are also subject to a cap of 25-35 percent of stock (depending on the size of the thrift) (Luse 1997a: 9). For the first three years after the conversion, OTS regulations cap individual ownership at 10 percent of stock. For a one-year period, managers may not sell stock they acquired in the initial subscription. After the first three years, acquiring more than 25 percent of stock requires OTS approval (Luse 1997a: 8 and Smith and Underwood 1997: 30-34).

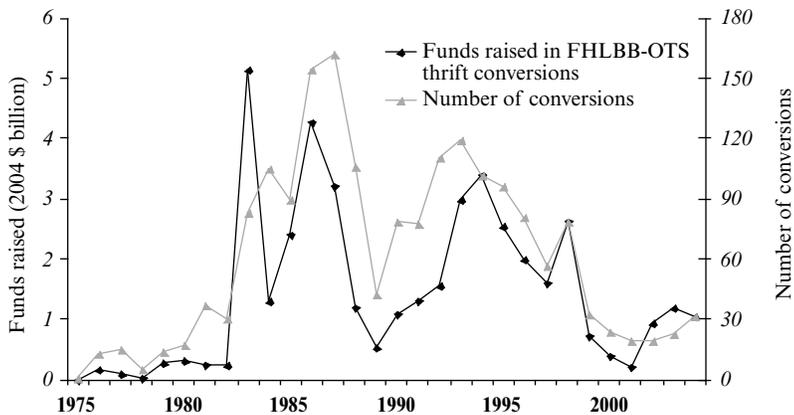
For the first year after the conversion, OTS regulations also cap recognition and retention plans at four percent and stock option plans at ten percent of the shares issued in the offering. The rationale for these plans is to align the interests (and compensation) of managers and directors with those of shareholders (see section IV A). Recognition and retention plans provide stock, paid by the institution, to some managers and directors. These plans generally vest over extended periods (typically five years), requiring recipients to remain in the institution. Stock options typically give managers and directors the option to buy shares at later dates at the price when the option was granted. Recipients of stock options benefit if, partially as a result of their management, stock prices increase between the two dates. OTS regulations also require stockholder votes before converted thrifts institute recognition and retention plans and stock option plans (Luse 1997a: 10 and KBW 2001: 6).

Whereas state-chartered mutual savings banks were (are) not regulated by the FHLBB (the OTS), the regulation of conversions by the FDIC and state regulatory authorities has been largely similar to that of the FHLBB and OTS (OTS 1994a: 3 and ACB 2003: 3). However, some differences remain. For instance, the OTS generally requires converted credit unions to operate as a mutual for at least one year before entertaining an application to convert into the stock form (OTS 2001).

In contrast, Allied Pilots FCU converted from a credit union into a state-chartered mutual savings bank regulated by the FDIC on September 1, 2001 and conducted its subscription offering on December 12, 2001, carrying out a credit union-to-mutual thrift-to-stock thrift conversion considerably faster than one year (KBW 2001: 3, 24).

Figure 2 displays the annual number of mutual-to-stock thrift conversions identified by the FDIC, the FHLBB, and the OTS and the amount of capital (in 2004 dollars) raised by conversions of thrifts regulated by the FHLBB and OTS from 1975 to 2004. Table 10 in the appendix displays the annual number of mutual and stock thrifts, assets in mutual and stock thrifts, the number of mutual-to-stock thrift conversions, and the amount of capital raised by FHLBB-OTS conversions. Both series in figure 2 exhibit rough peaks in the mid-1980s and the early-1990s. The first peak follows (1) the high inflation and interest rates of the late 1970s and early 1980s that deeply depleted the net worth of many mutual thrifts and (2) the progressive relaxation of federal and state conversion legislation. The second peak follows the final stages of the savings and loan crisis. Between 1975 and 2004, the FDIC, FHLBB, and OTS identified 1,830 mutual-to-stock conversions and thrifts regulated by the FHLBB and OTS have raised \$43 billion (in 2004 dollars).

Figure 2: Number of mutual-to-stock thrift conversions and funds raised in thrift conversions regulated by the FHLBB and the OTS (1975-2004)



Sources: OTS (2005), FDIC.
 Note: The series for the number of conversions includes those for FHLBB- and OTS-regulated thrifts for 1975-2004 and those for FDIC-regulated thrifts for 1984-2004. The FDIC does not have reliable figures for conversions prior to 1984. However, there were fewer than twenty FDIC-regulated stock thrifts at the end of 1983.

Unless the number of credit union-to-mutual thrift conversions grows significantly, the annual number of mutual-to-stock conversions may be expected to remain low as the number of mutual thrifts remaining continues to shrink. Mutual-to-stock thrift conversions are relevant for credit unions since a high percent of credit unions that convert into mutual thrifts convert into the stock form and since professional depositors interested in conversions are shifting their attention from the shrinking number of remaining mutuals to the possibility of larger numbers of credit unions converting into mutuals (NCUA 2005: 11, Luse and Gorman 2005: 10, and CUNA 2005h).

IGA FCU, which converted into IGA Federal Savings Bank in July 1998, raised \$14.5 million in its subscription offering in October 1999, becoming the first former credit union to convert into the stock form (CUNA 2005b). Of the 17 credit unions that converted into mutual thrifts between 1995 and 2002 (i.e., excluding merger conversions and the most recent conversions in 2003, 2004 and 2006), six former credit unions have engaged in standard mutual-to-stock thrift conversions. An additional two former credit unions became full stock thrifts through other mechanisms. Eight other former credit unions have taken other steps away from mutuality, and only one former credit union (the former Sacred Heart of Charleston) remains a fully mutual thrift (see sections III C and D). Table 9 in the appendix lists all credit unions that have converted into mutuals and their current corporate form (including mutuals, stock thrifts, and intermediate steps).

C. MUTUAL HOLDING COMPANIES

In 1987 Congress passed the Competitive Equality Banking Act (CEBA) amending HOLA and permitting mutual thrifts to reorganize as mutual holding companies (MHCs). As in mutual-to-stock conversions, MHC reorganizations require OTS approval and the affirmative vote of over 50 percent of eligible votes (not of votes cast). Upon reorganization, an MHC owns a stock subsidiary⁹ (typically a thrift, but in at least one case a commercial bank, see section III D). In the MHC structure, the depositors of the subsidiary are the members of the mutual holding company and elect its board of directors (Luse 1997b, Smith and Underwood 1997: 39, FBR 2004: 135, and Ryan Beck 2004).

⁹ Since 1995, due to the tax treatment of bad debt reserves, MHCs increasingly use a three-tier structure with a mid-tier stock holding company that owns stock subsidiaries (Smith and Underwood 1997: 42 and Smith 1999a: 10).

When an MHC is first formed, it owns 100 percent of the shares in its stock subsidiary. Since no shares of stock have been sold to external (or internal) investors, this transaction is typically described as a reorganization, rather than a conversion. Until they sell stock to external investors, these institutions are referred to as private MHCs. The vote to reorganize as an MHC authorizes management henceforth to sell minority interests (up to 49 percent) in the stock of their subsidiaries. As long as they are in existence, MHCs must retain controlling interests (51 percent) in their subsidiaries. Subscriptions (i.e., sales) of stock by an MHC are commonly referred to as first-step or first-stage conversions and follow a ranking of subscription rights similar to those in a standard mutual-to-stock conversion. Even after stock is sold to external investors, MHCs may establish voting procedures in their stock subsidiaries under which a majority of stockholders (i.e., the MHC) may elect all the members of the board of directors, effectively preventing minority stockholders (i.e., external investors) from obtaining representation in the board of directors (Ryan Beck 2004: ii, 117).

Subject to OTS approval and an additional affirmative vote of over 50 percent of eligible votes (not of votes cast), MHCs may also engage in second-step or second-stage conversions. In these transactions, the MHCs are dissolved and the transition from partial to full stock ownership is completed. New shares are sold for the appraised value of the MHC majority interest in the subsidiary. The original minority shares of stock are cancelled and are exchanged for newly-issued shares at an exchange ratio such that the percent of outstanding shares held by the original minority shareholders remains constant before and after the offering. Subscription rights for shares of stock in second-stage conversions also follow a ranking of subscription rights that is similar to those in standard mutual-to-stock thrift conversions (SNL 1999: 5, FBR 2004: 135, KBW 2004: 1-4, and Ryan Beck 2004: xii and 105).

In July 1988, People's Bank, located in Connecticut, was the first mutual thrift to reorganize as an MHC and engage in a first-step conversion. In August 1994, Jefferson Bancorp, located in Louisiana, was the first MHC to engage in a second-step conversion (Smith 1999a: 8). Between 1988 and 2004, about 200 mutual thrifts reorganized as MHCs, 81 engaged in first-step conversions, and 53 engaged in second-step conversions. Typically, three or four years elapse between the first and second steps (Silver 1999: 14, Smith 1999a: 9-10, ACB 2005, and Luse and Gorman 2005: 13-14). First- and second-step conversions are becoming the preferred means of converting. Out of 25 thrift

conversions identified by a conversion specialist in 2004, three were standard conversions, seventeen were first steps, and five were second steps (Luse and Gorman 2005: 10).

Among the 10 former credit unions to have reorganized as MHCs, two remain as private MHCs, including Lusitania, the first credit union to convert into a mutual thrift. In September of 2002, Synergy Bank became the first of six former credit unions to engage in first-step conversions. In January 2004, Synergy Bank also became the first former credit union, and thus far the only one, to engage in a second-step conversion.

D. OTHER CONVERSIONS

The previous sections discuss the most common mutual-to-stock conversions affecting credit unions and former credit unions. However, there are other types of conversion transactions that are relevant to a full discussion of credit union conversions. These include conversions of stock thrifts to commercial banks, conversions from commercial banks to stock thrifts, conversions from the stock form to the mutual form, and conversions from mutual thrifts to credit unions. Figure 3 summarizes graphically the main types of conversions presented in this report.

Figure 3: Main types of conversions among depository institutions

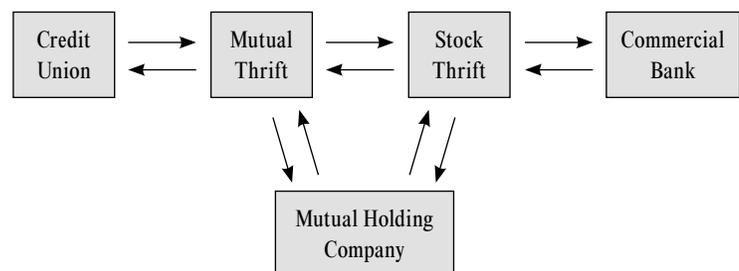


Table 1 displays annual conversions of thrifts into commercial banks, unassisted mergers of thrifts into commercial banks (i.e., mergers in which the resulting institution has a commercial bank charter), assisted mergers of thrifts into commercial banks (i.e., mergers encouraged by regulators to avoid the liquidation of a thrift), and conversions of commercial banks into thrifts. Whereas the number of institutions switching to commercial bank charters far outweighs the number of institutions switching charters in the opposite direction, table 1 shows

that neither charter may be best suited for all institutions at all times and that many institutions may find it beneficial to switch charters in either direction. For instance, some thrifts may find that complying with the QTL test is unprofitable and may choose or be required to convert into commercial banks (Silver 1997a and Ryan Beck 2004: 105-106 and 110-111). In contrast, some commercial banks may find that the investment and lending limits implied by the QTL test are not particularly constraining and may prefer the branching powers of the federal thrift charter.

**Table 1: Number and types of conversions
between thrifts and commercial banks (1984-2004)**

| | Stock thrifts converting into commercial banks | Unassisted mergers of stock thrifts into commercial banks | Assisted mergers of thrifts into commercial banks | Commercial banks converting into stock thrifts |
|--------------|---|--|--|---|
| 1984 | 1 | 0 | 0 | 2 |
| 1985 | 1 | 1 | 0 | 0 |
| 1986 | 0 | 1 | 1 | 1 |
| 1987 | 2 | 1 | 1 | 3 |
| 1988 | 0 | 1 | 0 | 2 |
| 1989 | 1 | 5 | 0 | 0 |
| 1990 | 14 | 13 | 10 | 0 |
| 1991 | 23 | 26 | 15 | 0 |
| 1992 | 8 | 33 | 15 | 2 |
| 1993 | 12 | 61 | 1 | 0 |
| 1994 | 14 | 67 | 0 | 3 |
| 1995 | 15 | 63 | 1 | 5 |
| 1996 | 10 | 60 | 0 | 5 |
| 1997 | 39 | 77 | 0 | 11 |
| 1998 | 16 | 63 | 0 | 9 |
| 1999 | 15 | 46 | 0 | 7 |
| 2000 | 11 | 53 | 1 | 5 |
| 2001 | 14 | 33 | 0 | 4 |
| 2002 | 11 | 28 | 1 | 2 |
| 2003 | 12 | 25 | 2 | 2 |
| 2004 | 18 | 29 | 0 | 7 |
| Total | 237 | 686 | 48 | 69 |

Source: FDIC (2005).

Stock thrift-to-commercial bank conversions are relevant to credit unions since former credit unions may convert into, or be acquired by, commercial banks. For instance, IGA FCU first converted into IGA Federal Savings Bank, a mutual thrift, in July 1998. After converting to a stock thrift and raising \$14.5 million in stock in May of 1999, it

merged with (i.e., was acquired by) PSB Bancorp of Philadelphia in November 2000 for \$24 million in a cash transaction. Thus IGA is no longer an independent entity and its branches are now operated by First Penn Bank, a commercial bank (Reosti 2002 and CUNA 2005b).

Some conclude from the current wave of conversions that it is natural for most mutuals to eventually convert into the stock form. However, changes in ownership structure may be a two-way street. For instance, at the start of the twentieth century, scandals in the US insurance industry prompted the passage of statutes that permitted the mutualization of stock companies and subsequently led to a wave of mutualization. Companies such as Prudential, Metropolitan Life, and the Equitable which had begun their operations as stock companies converted into the mutual form (Swiss Re 1999: 24-25 and Chaddad and Smith 2004: 582). Section IV discusses in further detail why companies might change their ownership structure from the mutual to the stock form and vice versa.

Further, conversions from the stock to the mutual form are not exclusive of insurance companies. Section 5 (i)(1) of HOLA provides for both mutual-to-stock and stock-to-mutual thrift conversions. Also, while relatively rare, between 2000 and 2004, there were eight “remutualization” transactions in which mutual thrifts acquired publicly-traded MHCs and bought out external stockholders (Luse and Gorman 2005: 13).

There have also been at least two mutual thrift-to-credit union conversions. The Eastman Savings and Loan Association was chartered in 1920 by George Eastman, founder of Eastman Kodak Company, to help company employees obtain housing. Like a credit union, the thrift’s membership had been circumscribed to employees for much of its history. On February 1, 1996, the thrift formally converted into ESL FCU. The credit union’s field of membership includes employees and retirees of Eastman Kodak Company and its subsidiaries, residents of Rochester, New York, and certain other related groups. Similarly the Employee’s Mutual Saving, Building and Loan Association (EMSBLA) of Wisconsin Electric converted into EMSBLA Credit Union on November 1, 1997 (ESL 2005 and EMSBLA 2005).

Sections III A, B, and C, and figure 3 attempt to summarize the main types of conversions and their steps. However, more possible routes in the conversion process continue to surface. For instance, Ohio Central FCU converted into a mutual thrift, Ohio Central Savings, in June

1998. In September 2001, it reorganized as an MHC and became a wholly-owned subsidiary of Third Federal Savings and Loan of Cleveland, a private MHC. However, in March 2005, Ohio Central was spun off from Third Federal as an independent stock thrift through a subscription offering to members and external investors. Thus, Ohio Central reorganized as a private MHC, did not issue minority stock, skipping a first-step conversion, and converted into a fully-stock-owned entity, also skipping a second-step conversion (KBW 2005). In another example, Community Schools Credit Union converted into a mutual thrift, Community Plus, in January 2002, subsequently reorganized as a private MHC, and in June 2005 merged with (i.e., was acquired by) another former credit union, Citizens Community Federal, which had earlier engaged in a first-step conversion (CU Journal 2005g).

Also, conversions and financial and legal engineering may be used to grant mutual institutions greater investment and lending powers. In 1998, First Bank Richmond, an Indiana state-chartered mutual savings bank, reorganized as a MHC that owns a commercial (national) bank as its stock subsidiary. Since the MHC has not sold any of the subsidiary's stock to investors, this institution is an example of how to combine full mutuality (i.e., the absence of external stockholders) and the full investment and lending powers of a commercial bank (First 2005).

Other examples of conversions not included in figure 3 include credit union-to-commercial bank and commercial bank-to-credit union conversions. The former route is not forbidden under the FCU Act (Albin 2000) and is discussed further in section V C as a possible alternative to avoid the shortcomings (discussed in section IV B) of OTS (and FDIC) conversion rules. Legal provisions for commercial bank-to-credit union conversions were proposed by CUNA in 2005 (CUNA 2005e).

SECTION IV: Issues And Incentives In Conversions

Section IV A addresses governance issues in mutual and stock companies. Section IV B explores how the rights to retained earnings of institutions engaging in mutual-to-stock conversions (including former credit unions) are allocated to various groups of internal stakeholders and external investors under current regulations. Section IV C recaps the reasons to convert that are sometimes put forth by converting credit unions, conversion specialists, and critics of conversions. Section IV D presents a preliminary conceptual approach that highlights the conditions under which average credit union members might benefit (or not) from converting (or from accessing the retained earnings in their institution). Section IV E presents, compares, and analyzes statistically the financial characteristics of converting credit unions and of samples of non-converting credit unions. Noting the systematic differences between credit unions that are converting and those that are not converting may also shed some light on which credit unions are more or less likely to convert in the future, and why they might choose to convert or not.

A. GOVERNANCE IN MUTUAL AND STOCK COMPANIES

This section presents and uses agency theory to analyze governance in conventional shareholder-owned companies (or stock companies) and in mutually-owned companies (or mutuals). To analyze ownership structures, agency theory views companies as webs of interlocking contracts among various stakeholders. In depository institutions, the key stakeholders are customers, managers, and owners. Agency theory then seeks to explain (1) how and why the ownership structures of companies differ from each other, (2) how incentives differ across ownership structures and how various (groups of) stakeholders respond to the different incentives that arise across these two different ownership structures, and (3) how companies with different ownership structures respond to changes in economic and regulatory conditions.

Customers make deposits in exchange for interest and liquidity services, pay interest in exchange for loans, and pay fees for a variety of services. Managers receive compensation for deciding how to organize, finance, and run companies. Managerial compensation packages are designed to provide incentives that are aligned with the interests of the ultimate owners of their institutions. Owners provide capital, which entitles them to the institution's residual income. The defining difference between stock and mutual companies is that (1) customers and owners

are typically separate parties in stock companies, while (2) members are both the customers and owners of mutuals.

Agency theory posits that each group of stakeholders has its own interests and that each group contracts with the company in order to jointly maximize the value of their separate interests. Whereas the interests of various (groups of) stakeholders may sometimes coincide, they may also conflict with one another. A given group of stakeholders may find that some actions that detract from the company's overall value (and from the value received by other stakeholders) transfer value to their group. Reductions in the overall value of a company that stem from such actions are referred to as agency costs (Fama 1980, Swiss Re 1999: 7, and Chaddad and Cook 2004: 576).

The most common examples of conflicts between (groups of) stakeholders are (1) those between customers and owners and (2) those between managers and owners. Customer-owner conflicts sometimes arise when managers, acting in the interests of owners, have substantial discretion to increase earnings for owners at the expense of customers. For instance, managers in life insurance companies might fund increases in shareholders dividends by depressing policy reserves for extended periods of time (Swiss Re 1999: 9). In insured depository institutions, managers might also engage in excessive risk-taking or hold insufficient amounts of capital and thereby increase the likelihood of transfers to owners from creditors, uninsured depositors, and the public sector.

Manager-owner conflicts sometimes arise when managers can use their discretion to pursue their own interests at the expense of the interests of owners. For instance, managers might grant themselves extensive non-monetary perks or reduce the risks to their future positions and incomes by taking too few risks and thereby reducing potential profits relative to the risks that owners who have diversified portfolios might find most appropriate.

Stock companies are generally thought to be better able than mutuals to control the manager-owner conflict, but less able to control the customer-owner conflict. In publicly-traded stock companies, share prices provide owners an external indicator of company performance that can be used to assess managerial performance and then to hold managers accountable. The share prices of publicly-traded companies are generally regarded as readily available, widely understood, and economically-relevant indicators. Share prices are typically monitored and determined by the financial analysts, large institutional investors, and the broader financial markets. In turn, owners may use share prices

to tailor compensation packages (e.g., stock option and stock grant plans) to provide managers with incentives to make decisions (e.g., about risk-taking, cost-cutting, and business strategies generally) that are aligned with shareholder interests. Thus, decisions that increased stock prices benefit both owners and managers and that depressed stock prices hurt both owners and managers. Sufficiently poor stock price performance might lead to the ouster of managers by either existing shareholders or by new shareholders who purposely purchased depressed shares based on the conviction that the company's assets could yield better returns under new management (Rasmusen 1988: 396-400 and Swiss Re 1999: 9-13).

Mutuality has its advantages. Mutuals are generally thought to be better able to eliminate the customer-owner conflict, but less able to control the manager-owner conflict than stock companies. By foregoing tradable shares of stock, which typically have readily observable prices, mutuals eliminate potential conflicts of interest between customers and owners. Free from the scrutiny of outside (actual and potential) investors, managers might pay less attention to short-term performance and to focus on initiatives that ultimately benefit the member-owners of mutuals. Further, having members as their single constituency might yield pricing advantages for mutuals. Some argue that, by not having to pay dividends to stockholders, mutuals might provide products and services to their members at lower total cost (Malizia 1998, Swiss Re 1999: 8-12, Daily 2000, and ACB 2005).

Foregoing tradable shares of stock, however, may also have a number of disadvantages, such as difficulties raising capital that might limit growth, limits on their pricing advantages if they seek to grow, difficulties attracting appropriate managers, insufficient control of managers by members, and difficulties aligning the interests of managers and members (Fama 1980). Wilcox (2002 and 2003) discusses how mutuals have often found that they cannot raise capital as easily and quickly as stock companies, and how that may limit their ability to meet capital requirements and/or grow.¹⁰ Since capital generally cannot be raised from non-members, mutuals often find that they cannot provide products and services at cost. Rather, mutuals sometimes feel compelled to retain sufficient earnings to ensure their future financial strength and to finance their growth (Daily 2000).

¹⁰ Mutual thrifts may be able to issue subordinated debt that helps them meet their capital requirements. However, only low-income credit unions may do so.

Absent stock prices, members of mutuals generally lack an indicator of company performance that is (1) externally provided and validated, (2) readily-available, and (3) not strictly based on internal accounting measures, which might be subject to some managerial discretion. Lacking such an indicator and stock-related compensation packages, many managers of mutuals may reckon that if their abilities raise the overall value of a mutual, very little of that increase in company value would accrue to themselves and almost all would accrue to members. A weak link between performance and compensation then might limit the ability of mutuals to attract and retain the most appropriate managerial talents and effectively to restrict mutuals to hiring from (1) the narrower pool of managers ideologically committed to mutuality and (2) the less desirable pool of managers who prefer that their compensation not reflect their personal performance (Swiss Re 1999: 3-9 and Ryan Beck 2005).

In some mutual thrifts, formal limits on voting rights weaken member control over managers. As discussed in section II B, members of some mutual thrifts may not even have formal voting rights. In mutual thrifts where members do have formal voting rights, those rights may be explicitly limited to electing directors, approving periodic amendments of bylaws, and voting on conversions and voluntary liquidations. Moreover, most members of mutual thrifts sign running proxies that allow managers (until the right is revoked) to cast votes on behalf of members at the managers' discretion even on matters as important as mergers (Smith and Underwood 1997: 16-17 and Smith 1999a: 8).

Even in mutuals (or cooperatives) with more formally-democratic voting structures (e.g., credit unions), member control over management is typically weak. Despite the perhaps more democratic structures of credit unions, few members use their voting rights and rival slates in elections, say for directors, are rare. Member participation rates are low even in votes about matters as momentous as conversions (see section III A) and in elections that follow highly-publicized, failed attempts at conversion and have rival slates of candidates.¹¹ Annual meetings are often little publicized and attended by few or no members other than the credit union's own managers, directors, and employees. As a result, most boards of directors in mutuals tend to be self-perpetuating (Rasmusen 1988: 395-398, Malizia 1998, Swiss Re 1999: 3, and Chaddad and Cook 2004: 581).

¹¹ For instance, recent elections with rival slates for directors in Columbia Community Credit Union attracted only 8 percent of members (CUNA 2005f).

There are several commonly-alleged reasons why members exert little control over the managers of mutuals. First, ownership is diffused across a large number of members who typically each hold quite small stakes. Second, managers often control member meetings and provide members with limited means to communicate with other members. Third, absent tradable shares of stock, discontented members cannot convey their opinions more forcefully by selling shares of stock and thereby depressing its price, which might otherwise influence or punish managers. And, fourth, limits on the number of votes per member prevent discontented, concerned members from amassing the controlling stakes of shares that might otherwise be used to garner seats on boards of directors and to remove managers. Since their individual benefits from active monitoring of the mutuals as a whole would then typically fall far short of the costs to them individually, most individual members do not actively monitor managers (Akella and Greenbaum 1988: 422, Rasmusen 1988: 396-398, Smith and Underwood 1997: 18, and Chaddad and Cook 2004: 581).

Government regulations, managerial efforts to avoid institutional failure, and competition to pay and charge market interest rates do provide limited brakes on managerial actions. But these influences are usually not deemed sufficient to align the interests of managers and members. Thus, following on these arguments and evidence, the assessments of many observers are that managers of mutuals are largely self-controlled, rather than answerable to their members. In the rhetoric of critics, without *de facto* rights, *de jure* ownership by members is just a formality, the corporate governance of mutuals is farcical, and mutuality is but a euphemism for entrenched management (Akella and Greenbaum 1988: 422, Smith and Underwood 1997: 17, and Daily 2000).

Absent effective means for members to control managers and a transparent, readily-available indicator to help assess company performance, it is difficult to align the interests of owners and managers. Instead, (1) the compensation of managers in mutuals is not clearly linked to providing additional value to members, (2) compensation is often linked importantly and perhaps primarily to the size of the institution, and (3) managerial income is typically undiversified (i.e., income is largely dependent on company survival). As a consequence, (1) managers of mutuals do not have strong financial incentives to cut noninterest costs, lower interest rates on standard loans, make higher-risk loans, or increase interest rates on savings and (2) have strong financial incentives to accumulate larger reserves (retained earnings)

and increase the size of their institutions (Smith et al. 1981, Rasmusen 1988: 396-400, and Kane and Hendershott 1996: 1324).

Because the compensation of managers of mutuals is not clearly linked to providing additional value to members, managers may grant themselves other forms of non-monetary compensation (i.e., perks). These perks may include fringe benefits (e.g., conferences in and business trips to desirable destinations), extra-enjoyable working conditions (e.g., buildings, furniture, and decorations), low managerial effort (e.g., fewer hours of work or less strenuous work for the same pay), nepotism (e.g., hiring less-qualified relatives, friends, or simply people who are pleasant to have around), and increased personal power and prestige (e.g., heading large workforces and granting low-interest and/or high-default loans to projects with which the manager may sympathize). Thus, insufficiently strong incentives to corral costs may lead to excessive perks, and resulting high costs, at mutuals (Akella and Greenbaum 1988: 429 and Rasmusen 1988: 396-9).

In addition, members of a mutual do not necessarily benefit most if the mutual avoids most risks. Just as excessive risk can substantially raise the likelihood of an institution failing, it is possible to take too little risk. For instance, a mutual could concentrate its investments in short-term government securities (just as a money market mutual fund does) and avoid higher-risk, higher-interest rate, and presumably higher-net-return member business loans and loans to members that cannot readily obtain credit elsewhere because they do not have good, or any, credit histories. Portfolios that avoid risk-taking excessively would require less managerial effort and provide managers with continued incomes and a quiet life, but would be unlikely to serve the credit needs of the actual and potential members of credit unions and would provide reduced interest rates on the assets of actual and potential members (Rasmusen 1988: 396-7, Kane and Hendershott 1996: 1310, Emmons and Schmid 1999, and Smith and Woodbury 2001).

To compensate for the absence of stock prices as a performance measure and a managerial incentive mechanism, mutual depositories may use other means to (1) measure company performance, (2) resolve conflicts of interest among their stakeholder groups, and (3) limit agency costs. Though stock companies may also use some of these means, the absence of stock prices make them of particular interest to mutuals.

The accounting measures (e.g., return on assets, ROA) commonly used to measure the earnings (or value) provided by stock companies

to their owners (i.e., their stockholders)¹² do not capture all the value provided by mutuals to their owners (i.e., their members). To obtain value for their roles as owners, members of a mutual must receive value in excess of what they would receive as non-stockholding customers of a stock company. There are several avenues for mutual depositories to provide ownership benefits to members: (1) better borrowing opportunities than would be available to them elsewhere in terms of rates, credit limits, types of loans, and other terms and conditions, (2) better savings opportunities than would be available to them elsewhere, (3) better financial services than would be available to them elsewhere, (4) nonpecuniary benefits, perhaps such as personal satisfaction from being a member rather than solely a customer of one's depository, and (5) perhaps, greater confidence that mutuals will survive to provide these same benefits in the future.

The totality of these benefits are not reflected in the reported ROA of mutuals. Thus, ROAs of mutuals are not directly comparable to ROAs of stock companies. Smith et al. (1981: 519-520) propose a theoretical measure that captures some of the ownership value that flows to members. Their measure adds to reported ROA both benefits received by member-borrowers who pay lower rates than those available on comparable loans at stock companies and the benefits received by member-savers who receive higher rates than those available on comparable savings products at stock companies.

It may be difficult in practice to measure precisely these two additional components of ownership value. One useful feature of this broader measure of the benefits of ownership is that it highlights the potential conflicts in mutual depositories between the interests of various groups of members. In general, we might well expect that the memberships of mutual depositories are more heterogeneous than those of other mutual organizations (such as food cooperatives). While many members have savings that vastly exceed their borrowings, others borrow vastly more than the amounts of their deposits.

Because mutual depositories turn the savings of some members into lending to other members, all else equal, charging less interest to member-borrowers translates into less wherewithal to pay interest to member-savers. Whereas member-borrowers (savers) are unlikely

¹² ROA describes the distributed and undistributed earnings provided by stock companies to their owners. Companies may distribute a fraction of these earnings as cash dividends to stockholders. Stockholders may also receive value, in anticipation of the distribution of past and future earnings, through higher stock prices.

generally to agree to borrow (deposit) at higher (lower) rates than those available elsewhere, Smith et al. (1981: 519-520) argue that internal politics (or perhaps managers) are likely to determine how the total benefits are split between savers and borrowers.

The effectiveness of the mechanisms that mutuals use may rise and fall as economic and regulatory conditions change. For instance, default risks at mutual depositories with closely-linked memberships, all else equal, have likely been lower than at more diffused mutuals. The repeated interactions among members, peer monitoring, social sanctions, and the requirement of co-signers for borrowers without good established credit records each likely improved repayment records (Smith 1984: 1155 and Banerjee et al. 1994: 491-2). The contributions of these factors to lowering loan default rates are likely to taper off in mutuals that grow in size and diversity.

Mutuals have also used market-based mechanisms to address their agency costs, with varying degrees of success. For instance, some mutuals have used compensation programs that reward key employees according to terms that are quite comparable (apart from any direct tie to stock price performance) to their stock company counterparts. Such programs may reduce the gap between the average levels of compensation of managers in mutuals and stock companies, but they may do little to align the interests of managers and owners, which presumably was, or at least should have been, the primary goal of introducing the more incentive-laden programs (Swiss Re 1999: 13).

By contrast, extensive bonding of managers and *ex ante* deposit coinsurance are often thought to have successfully controlled managers. Mutuals often bond their managers more extensively than stock companies. Bond (or surety) companies are liable for a broad range of managerial mistakes in the institutions they cover and, thus, have strong incentives to complement whatever monitoring that the regulators are providing with their own active, private-sector monitoring. The *ex ante* coinsurance characteristics of NCUSIF share insurance also mean that individual credit unions are punished or rewarded based on the performance of other credit unions, providing incentives for cross-monitoring of corruption and incompetence among managers. Thus, managers from other credit unions and government examiners routinely provide many of the tips that lead to audits by bonding companies. Although the individual benefit that would be expected to result from such tips might be quite small, the cost of

providing the tip might be much smaller (Kane and Hendershott 1996: 1311-13 and Wilcox 2002 and 2005).

Private-sector monitoring would also be vastly enhanced if much more subordinated debt of mutual depositories were outstanding. To protect their investments, holders of uninsured debt could have strong incentives to monitor the conditions and operations of the institutions that issued debt. The monitoring benefits that would arise from having outstanding subordinated (to the deposit or share insurance fund) debt have been touted for publicly-traded, oft-analyzed banks. Just as the one-eyed man is king in the land of the blind, having one set of private-sector monitors offers the potential of adding considerably to the amount and quality of information about mutuals that is public (Kane and Hendershott 1996: 1311-13 and Wilcox 2002 and 2005).

In addition, agency theory also predicts the following: (1) that various types of companies will compete to attract customers, managers, and owners, (2) that stakeholders will sometimes find that changing external conditions makes it beneficial for them to switch to companies that have different ownership structures, and (3) that some firms are likely to respond to changing external conditions by changing their ownership structure. Over long periods, any given type or structure of company will thrive only if it can generate value for stakeholders that are quite comparable to the alternatives.

However, agency theory does not imply that either the stock or the mutual ownership structure will prevail at all times or under all conditions. Patterns of ownership structure may differ by industries, across time periods, and under different economic and regulatory environments. Thus, changes in ownership structure, either into or out of the mutual form for example, can be triggered either by stakeholders (e.g., who can take their savings and borrowings elsewhere) or by companies (through formal conversions) (Chaddad and Cook 2004: 577).

Some have argued that stock and mutual depositories could easily coexist prior to the existence of federal deposit insurance. Then, managers of stock depositories might specialize in providing savers (depositors) and investors (stockholders) with higher-risk, higher-interest, higher-return saving and investment options. Those returns would have been funded by the higher-risk, higher-default-and-interest-rate loans and investments on the books of the stock depositories. Managers of stock depositories who had stock-price-related compensation would have the chance to benefit because they would, in effect, be stockholders.

In contrast, managers of mutual depositories might provide savers with a set of lower-risk, lower-interest options. Managers of mutual depositories might then have compensation programs that offered to them both lower-average and lower-risk incomes. And, indeed, from the nineteenth century through the Great Depression, mutual depositories failed far less often than stock depositories (Rasmusen 1988: 405 and 413- 414). The evidence since the Great Depression follows the same pattern (Wilcox 2005).

Some have also argued (1) that by making stock institutions lower-risk for most depositors, federal deposit insurance could alter the balance between stock and mutual depositories and (2) that to maintain that balance, mutual depositories need some other form of government assistance (such as lower taxation). Such a shifting of the balance might help explain why mutual thrifts have shrunk relative to stock thrifts as their tax exemption was gradually lifted (Akella and Greenbaum 1988: 430 and Rasmusen 1988: 409), while, over the same period, tax-exempt credit unions have thrived. Others argue that mutuals do not need tax exemptions to thrive (Scott 2003).

Sections IV B and C shift the discussion to address the incentives embedded in the standard conversion method under OTS (and FDIC) rules.

B. WHO GETS THE RETAINED EARNINGS?

This section describes how, as a matter of public policy as embodied in reigning law and regulation, retained earnings are allocated in mutual-to-stock conversions of thrifts under current OTS (and of mutual savings banks under current FDIC) rules. This section also contains an economic analysis that shows that, if members do not purchase stock *pro rata* to their deposits, part of members' joint claims on retained earnings may be transferred to external investors or to members (including managers and directors) who buy stock in excess of their *pro rata* share of deposits. Here we see that public policy tends to place its emphasis on (accumulated) retained earnings primarily to ensure the financial soundness of thrifts. We close section B with an examination of the economic repercussions of the standard method of conversions for undercapitalized and for highly-capitalized thrifts (and former credit unions).

There is widespread agreement that members have the best claim on the retained earnings of their mutual thrifts (Silver 2000: 2).

However, under current OTS (and FDIC) mutual-to-stock thrift conversion regulations, if members approve a conversion, their joint claim on retained earnings is not exchanged for shares of stock or cash in proportion to their deposits (see section III B). Instead, upon conversion, their *pro rata* claims on retained earnings are exchanged for (1) individual, nontransferable, preferential rights to purchase stock and (2) individual claims to retained earnings that would be senior to those of stockholders in liquidation. Table 2 provides a simple, hypothetical example of a conversion (all figures in millions of dollars).

Table 2: Retained earnings and new capital in a standard mutual-to-stock thrift conversion

| Panel A | | | | Panel B | | | |
|---------------------------------|-----|-------------------|----|------------------|-----|-----------------------|----|
| Mutual thrift before conversion | | | | Converted thrift | | | |
| Assets | 100 | Deposits | 94 | Old assets | 100 | Deposits | 94 |
| | | Retained earnings | 6 | New assets | 6 | Old retained earnings | 6 |
| | | | | | | New capital | 6 |

Panel A of table 2 displays the assets and liabilities on the balance sheet of a mutual thrift. Before converting, members jointly owned the retained earnings. Panel B displays the thrift soon after a standard conversion under OTS rules. For simplicity, in this example we assume that the price-to-book ratio for other stock thrifts at the time of conversion is one, which is approximately its value at the end of year 2000 (Luse and Gorman 2005: 11). In this example, an independent appraisal determines the pro forma market value of the thrift to be \$6 million. As a consequence, the converting thrift sells \$6 million worth of stock (for instance 600,000 shares each priced at \$10) in subscription and public offerings, which are typically referred to as its initial public offering, or IPO. For this example, we ignore the costs of the IPO.

In connection with the conversion, the thrift does not distribute cash to members. As a result, after conversion, the thrift has \$6 million in additional (cash) assets and \$6 million in new capital. Members' claims on the retained earnings of the mutual thrift (other than their rights in liquidation) are in effect extinguished and replaced by their preferential rights to buy stock, not by stock. Whoever does buy the newly issued shares of stock then will own, in proportion to their holdings of shares of stock and not past or current deposits, the thrift. That ownership entitles them to the equity of the converted thrift, which immediately after the conversion consists in our example of the new \$6 million that they contributed when they purchased shares of stock – plus the old \$6 million of retained earnings that the former mutual thrift had accumulated over its entire existence (SNL 1999: 4).

If all members exercise all of their subscription rights and therefore purchase all of the newly issued stock, which would distribute stock in proportion to their recent, prior deposits, the claims on the (accumulated or old) retained earnings would be transferred *pro rata* to members. For instance, if the thrift had 10,000 members who each held \$9,400 in deposits and each member bought 60 shares (or one ten-thousandth of the shares issued), each member would then own one ten-thousandth of the converted thrift and have that claim on the net worth, future earnings, and potential stock appreciation of the stock thrift. The members who purchase stock (i.e., buying members) then have claims on the total equity of the converted thrift. That is, they have claims on both the cash that they contributed and on their *pro rata* share of the retained earnings. (Section V B further addresses how conversion rights might be modified so that the contributions to retained earnings that were made over time by depositors and borrowers could be rewarded.)

However, if members (as a group) do not purchase all of the shares of stock that are offered in the IPO, then they will, in effect, surrender their claims on retained earnings. In that case, in effect the retained earnings will accrue to external investors that do purchase the stock at the IPO. If individual members purchase some stock, but less than their *pro rata* share of deposits entitles them to purchase, members will have partially surrendered their claims on the thrift's retained earnings.

There are any number of reasons why individual members may not purchase shares of stock, including judging that they do not have access to the cash to pay for the shares of stock, not being familiar with equity markets in general, or not understanding the details of the conversion transaction (Smith and Underwood 1997: 31, SNL 1999: 4, and Swiss Re 1999: 26).

In addition, some members might be depositors at mutuals as a matter of personal preference for mutuals over stock depositories. If so, those members might have a (nonfinancial) aversion to become shareholders in stock depositories. If they shun purchasing shares in their converting mutual, perhaps ironically, they allow retained earnings from their former mutual thrift to accrue to the external investors in the stock thrift. To surrender the accumulated net worth of a mutual thrift to the group that generically owns and runs the stock thrifts that such mutual members deliberately avoided might well be a consequence that such mutual members had not intended.

If, for instance, members holding 50 percent of deposits buy no stock (henceforth: non-buying members), other members buying

stock in excess of their *pro rata* share and external investors would gain claims to the 50 percent of old retained earnings foregone by non-buying members (or \$3 million). Regulations provide for a link between the amounts of member deposits and the amounts of shares of stock purchased when members want to buy more shares in total than are available. Such regulations, however, have been activated only rarely (SNL 1999: 7 and KBW 2001: 41-42). Historically, only a relatively small percent of members purchase shares of stock via the subscription offerings. That means that the remaining stock is typically available for purchase by external investors. Among former credit unions, for instance, only five percent of members bought stock when former IGA FCU conducted its subscription offering (SNL 1999: 6 and CUNA 2005b).

In contrast, well-informed “insiders” (i.e., managers and directors of converting credit unions) typically purchase a large fraction of the shares of stock that are offered in conversion IPOs. Insiders also may effectively purchase additional amounts via their employee stock ownership plans (ESOPs). The surrendered claims of non-buying members accrue to members (including insiders) who purchase more than their *pro rata* number of shares and to external investors.

According to a survey by The Credit Union Journal, managers and directors have acquired voting control of nearly all (mutual-to-stock) converting credit unions. For instance, managers and directors of the following former credit unions own (and control through ESOPs and charitable foundations) 12 percent (and 16.5 percent) of Rainier Pacific, 15 percent (and 9.9 percent) of Pacific Trust, 21.1 percent (and 8.9 percent) of BUCS, almost a third of Citizens Community, 24 percent of Allied First, and 17 percent of Atlantic Coast (CU Journal 2004a and 2005i).

Some investment publications specialize in providing information about thrift conversions. These publications routinely point out that conversion IPOs are very different from standard IPOs and that they routinely deliver outsized gains (“pops”) for investors (Colantuoni 1999: 2-3 and SNL 1999: 4 and 2005). In standard IPOs, the owners of privately-held companies sell some (or all) of their previously-unlisted shares to external investors, which transfers cash to the sellers in exchange for their ownership shares, but does not infuse cash or capital into the company. In addition, the IPO often involves the issuance of net new shares, which do bring additional capital to the company. In practice these two steps are often conducted simultaneously. Research

and folklore suggest that standard IPOs often have delivered some immediate gains for all shareholders who own shares before the first day of trading (“first-day pops”). That pop up to the market’s evaluation of the appropriate share price eliminates the underpricing of shares prior to trading. Why companies would knowingly underprice their shares is a matter of longstanding and considerable puzzlement and a matter of recent and public concern. Among the more justifiable reasons are that investors need to be compensated for the uncertainty of investing in a company that lacks a public track record and that companies want to ensure that IPOs are successful (e.g., that the desired amount of capital is raised).

By contrast, the transfer of claims on retained earnings from non-buying members to internal and external investors in conversion IPOs is reflected in even larger first-day pops. Consider three simple examples, where we assume perfectly liquid markets, perfect information, competent management, and a price-to-book ratio of one. If a mutual with \$10 million in retained earnings sold shares for \$10 million, the new owners would pay \$10 million and have claims on \$20 million worth of capital, implying a return of 100 percent on a single day. If the thrift sold shares for, perhaps implausibly, only \$1 million, the new owners would have claims on \$11 million, implying a return of 1,000 percent. On the other hand, even if the thrift sold shares for \$1,000 million, the new owners would have claims on \$1,010 million, implying a return of one percent. Thus, internal and external investors would benefit from a first-day pop as long as financial markets perceived that, after considering the value of its retained earnings and other characteristics, the pre-conversion company had positive economic value (Wilcox and Williams 1998, Colantuoni 1999: 2-3, and Morrison 2004d).

In practice, the size of first-day pops has varied across conversions. The pops are likely to depend on the amount of retained earnings, the size and liquidity of the offering, and investors’ assessments of the institution’s future earnings (Wilcox and Williams 1998). Table 3 shows that median first-day pops for thrift conversions varied widely during 1995-2004 across years and across conversion method (standard, first-step, and second-step).

Table 3: Median first-day pops in standard, first-step, and second-step thrift conversions (1995-2004)

| Year | Median first-day pop (%) | | | Number of | | |
|-----------|--------------------------|-------------|--------------|----------------------|-------------|--------------|
| | Standard conversions | First steps | Second steps | Standard conversions | First steps | Second steps |
| 1995 | 15.6 | 10.0 | 8.3 | 81 | 8 | 5 |
| 1996 | 9.8 | 20.6 | 6.2 | 63 | 2 | 7 |
| 1997 | 42.2 | 28.1 | 23.4 | 33 | 4 | 7 |
| 1998 | 28.1 | 12.2 | 6.3 | 40 | 14 | 11 |
| 1999 | 8.1 | 1.3 | -0.3 | 18 | 9 | 2 |
| 2000 | 10.0 | 2.5 | 6.7 | 11 | 4 | 3 |
| 2001 | 20.8 | 33.4 | 22.8 | 10 | 3 | 2 |
| 2002 | 22.8 | 26.2 | 9.5 | 6 | 4 | 3 |
| 2003 | 37.5 | 62.9 | 12.4 | 6 | 2 | 6 |
| 2004 | 13.2 | 20.0 | 0.0 | 3 | 17 | 5 |
| 1995-2004 | 18.2 | 20.3 | 7.5 | 271 | 67 | 51 |

Source: Luse and Gorman 2005: 13-14.

First-and second-step conversions each have some conceptual similarities to and differences from standard conversions. Standard and second-step conversions are similar in that they both involve final steps away from mutuality. As such, they typically involve uncompensated transfers of claims from non-buying members to buying members and external investors. First-step conversions differ in that mutual members retain formal ownership of at least 51 percent of the stock subsidiary. Standard and first-step conversions are similar in that they both involve the IPO of shares that then put a market price on the value of residual claims (shares of stock) on their entities. Second-step conversions differ in that shares of stock in their entities (albeit with formally different legal rights) traded prior to the conversion.

Table 3 shows that first-day pops for first step conversions have been broadly similar to those for standard conversions and that first-day pops for second steps have been much smaller. This pattern implies that, despite not having formally received uncompensated transfers of ownership, investors in first steps expect those transfers to take place eventually. The small size of first-day pops in second steps is likely explained by the existence of a market for the stock in the subsidiaries of MHCs which could reflect any expected conversion-related gains ahead of the actual second IPO (Luse and Gorman 2005: 13).

Table 4 presents the credit union-to-mutual thrift conversion date, the IPO date, the type of conversion IPO, and first-day pops for former credit unions that have, to date, conducted public offerings. There have been seven standard IPOs and six first-step IPOs. One of the MHCs

with a publicly traded stock subsidiary also had a second-step IPO. So far, the total number of IPOs and of each type of IPO is too small to perform reliable statistical analyses on the relationships between first-day pops, types of IPOs, and institutional characteristics (e.g., asset size) separately across former credit unions. Nonetheless, the data do show that the sizes of first-day pops for standard, first-step, and second-step conversions of former credit unions are generally in line with those of other converting thrifts during the same period.

Table 4: Initial public offerings (IPOs) in former credit unions (1999-2005)

| Name of former credit union | Credit Union to mutual thrift conversion date | IPO date(s) | Type of conversion IPO | First-day pop (%) |
|-------------------------------|---|--------------------|---------------------------|-------------------|
| AWANE FCU | 5/1/96 | 6/29/04 | First step | 3.8 |
| BUCS FCU | 3/1/98 | 3/15/01 | Standard | 30.0 |
| Synergy FCU | 5/1/98 | 9/18/02 1/21/04 | First step Second step | 29.3 9.0 |
| Affiliated FCU | 6/1/98 | 6/1/01 | Standard | 7.5 |
| Ohio Central FCU | 6/1/98 | 4/1/05 | Standard | 20.0 |
| IGA FCU | 7/1/98 | 10/5/99 | Standard | 8.6 |
| Kaiser Permanente FCU | 11/1/99 | 3/31/04 | First step | 34.9 |
| Pacific Trust FCU | 1/1/00 | 8/23/02 | Standard | 18.6 |
| Atlantic Coast FCU | 11/1/00 | 10/5/04 | First step | 17.5 |
| Rainier Pacific CU | 1/1/01 | 10/21/03 | Standard | 69.9 |
| AGE FCU | 7/1/01 | 6/30/05 | First step | 7.5 |
| Allied Pilots Association FCU | 9/1/01 | 12/31/01 | Standard | 19.0 |
| Citizens Community FCU | 12/12/01 | 3/30/04 | First step | 23.7 |
| Median | - | - | | 19.0 |

Sources: Ryan Beck (2005).

Note: Ohio Central first converted to a private MHC but did not engage in first or second-step conversions. IGA is no longer an independent institution. It merged with (i.e., was acquired by) First Penn Bank, a commercial bank.

The OTS argues that the standard conversion method is backed by numerous state and federal court decisions that determine that members' property rights to thrifts' retained earnings are very limited (OTS 1994b: 12 and ACB 2003: 5). For example, in 1877, the US Supreme Court ruled in *Huntington v. Savings Bank* that members owned the surplus (or retained earnings) of a thrift jointly and that those retained earnings existed to ensure the institution's long-term viability. The court stated that "the profits of which ... inure wholly to the benefit of the depositors, in dividends or in a reserved surplus for their greater security" (Smith and Underwood 1997: 10).

Other courts have ruled that thrift charters could restrict their members' ability to access, transfer, sell, or withdraw their *pro rata* shares in the retained earnings of ongoing institutions. For instance, in 1890 a

Rhode Island court ruled in *Mechanics' Savings Bank v. Granger* that “the depositor ... cannot withdraw any part of the reserve when he withdraws his deposit...” Thus, thrift charters may limit member claims on retained earnings to the event of liquidation. In 1887 a Rhode Island court ruled in *Morristown Institution for Savings v. Roberts* that “(Current) depositors being the only persons interested in the assets of the corporation at the time of winding up, are entitled to a ratable distribution among themselves, according to the amount of their respective deposits...” (Smith and Underwood 1997: 11-12).

Apparently ignoring the potential avenues through which mutuals may provide value to members, several courts have stated that members' ownership rights are negligible and amount to little more than the rights of creditors in stock institutions. For instance, the ruling in *York v. Federal Home Loan Bank Board* in 1980 stated that since “(d)epositors ... are not allowed to realize or share in profits ... and no solvent association has ever secured approval for dissolution ... depositors' only actual rights, their rights as creditors, will remain unchanged by the conversion” (Smith and Underwood 1997: 22). In light of this decision, the OTS argues that the effective claims of members on retained earnings are recognized by establishing liquidation accounts (OTS 1994b: 12). These accounts give those who are members at the time of the conversion claims during a subsequent liquidation that would be senior to those of stockholders. Of course, the economic value of these claims would likely be negligible since liquidations of solvent institutions are very rare (Akella and Greenbaum 1988: 422, CU Journal 2005d, and Wilcox 2005).

Other courts, including the New Hampshire Supreme Court in a 1973 decision regarding *In re City Savings Bank of Berlin and Berlin National Bank*, have upheld the legality of the standard conversion method. Further, that court argued that granting dissenting members the right to cash payments for their *pro rata* share of retained earnings would render conversion plans ineffective, and ruled that dissenting members could not use the cash-out option to prevent the majority of members from engaging in a conversion (Smith and Underwood 1997: 21).

This report does not present legal analysis of conversion issues. However, past court cases have not ruled that conversions based on the free distribution model or including cash-out options are unconstitutional or illegal. Rather, courts have ruled that legislators, regulators, and individual thrift charters may use the standard conversion method. Thus, past court decisions seem to offer legislators and regulators the

option to either require the standard conversion method or to permit that and other conversion methods. Thus, one of the purposes of this report is to explore how various conversion methods benefit different groups of stakeholders differently at different times and under different conditions.

The OTS has recognized that, given the workings of the standard conversion method in practice, managers and directors often have the opportunity to transfer to themselves considerable amounts of the value in converting institutions. The OTS argues, however, this standard method strikes an appropriate balance between those outcomes and the opportunity to infuse significant amounts of new capital into the thrift industry (OTS 1994a: 1). Balance might well be achieved via the standard conversion method under some financial and economic conditions, but it is unlikely that it can strike that balance irrespective of such conditions. Some policies appropriately reflect trade-offs under a variety of conditions. The standard conversion method, however, is not likely to be a policy for all seasons.

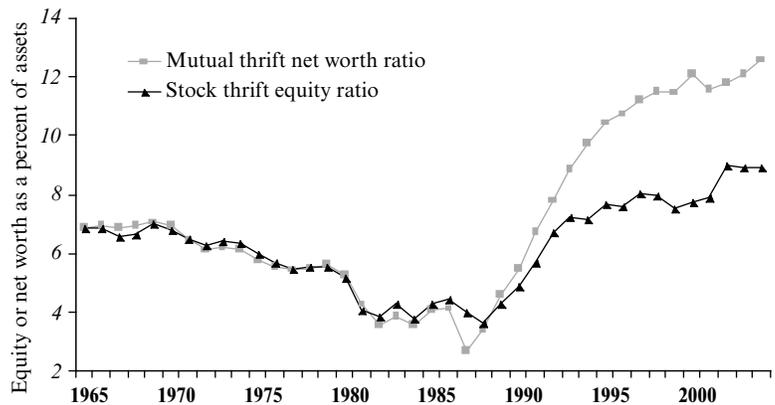
Many observers agree that, during and after the high and rising inflation and interest rates of the late 1970s and early 1980s, standard conversions helped to shore up the capital position of undercapitalized thrifts (Masulis 1987, Eccles and O'Keefe 1995: 5, and Chaddad and Cook 2004: 579).¹³ Figures 2 and 4 highlight the inflows of conversion-related capital into the thrift industry. Between 1975 and 2004, conversions among FHLBB- and OTS-regulated thrifts raised \$43 billion (in 2004 dollars) and helped to increase capital ratios in both mutual and stock depositories. (Conversions removed low-capitalized mutuals from the average of mutual thrifts and introduced re-capitalized thrifts into the average for stock thrifts). Moreover the minute levels of tangible equity (average ratios of 1.6 percent of assets) and small first-day pops (averaging 5.6 percent) among thrifts during 1980-89 highlight that the amounts of claims on retained earnings that were transferred from non-buying members to buying members and external investors were likely to have been relatively small. Part of the reason, in essence, for the small transfers was that conversion IPOs of severely undercapitalized thrifts

¹³ Additional capital, however, may at times be a mixed blessing. Eccles and O'Keefe (1995: 8-11) and Chaddad and Cook (2004: 579) report that the additional capital brought into New England savings banks through conversions depressed returns on equity (ROE) and created a constituency (stockholders) that favored fast asset growth, increased returns, and thus increased risk taking in areas such as commercial mortgages. Very high failure rates among those converted institutions imply that additional capital may not have provided an effective cushion against failure, but rather played a role in lowering credit quality.

(and in particular of economically insolvent ones) involve very little previously-accumulated economic value (Colantuoni 1999: 3).

Transfers of claims on retained earnings may not have been very troublesome by the latter 1980s, after the average (regulatory) capital-to-assets ratios among FSLIC-insured thrifts had fallen from 7.06 percent in 1969 to 3.61 percent in 1987 (FHLBB 1988). But, in general, the reported capital ratios and economic values of mutual thrifts have moved up smartly since then. Figure 4 shows that, with net worth to asset ratios having been over 10 percent for a decade, mutual thrifts as a group are far from undercapitalized today. Arguing that the appraisal methodology used by the standard conversion method is most appropriate when converting thrifts have negligible retained earnings or economic value, several observers conclude that the standard conversion method should only be used for conversions of severely undercapitalized thrifts (Unal 1997 and Colantuoni 1999: 3-4).

Figure 4: Mutual thrift net worth ratios and stock thrift equity ratios (1965-2004)



Source: FHLBB (1988) and OTS (2005)
Note: Data for 1965-87 is for FSLIC-insured thrifts. Data for 1989-2004 is for OTS-regulated thrifts. We interpolated the data for 1988 from the prior and latter samples. These equity and net worth ratios include broad definitions of accounting and regulatory capital and are, thus, likely to overstate thrift capital ratios based on narrower definitions such as tangible or economic capital.

Since the 1980s, both the net worth ratios of mutual thrifts and the first-day pops in thrift conversions have increased markedly. That they would closely track each other is hardly surprising. Citing growing concerns about the growing sizes of first-day pops, the OTS (and the FDIC) revised their appraisal standards in 1994 (OTS 1994a: 1 and Eccles and O’Keefe 1995: 5). The revisions in appraisal standards, however, did not much reduce the size of the pops in the years immediately afterward. As long as converting thrifts continue to transfer underlying economic

value from some members, we should expect to see price appreciation on the first day of trading that reflects the sizes of those transfers (Colantuoni 1999: 5).

In section V C, we present and discuss alternative conversion methods that may be more appropriate for highly capitalized thrifts than the standard method in that they would reduce the sizes of transfers of claims on retained earnings from members.

C. WHY CONVERT?

Credit unions likely have different reasons for converting. The reasons for credit unions to convert to mutual thrifts, for former credit unions to convert to stock companies, and for other types of conversions are largely implicit in the characteristics of various depositories (section II), in differences in governance (section IV A), and in incentives generated in practice by the standard conversion method (section IV B). To a large extent, the decision to convert (or not) involves weighing the advantages and disadvantages of different charters and of the conversion process. The factors involved in these decisions, however, may be complex. Given the conflicting interests of the various groups of stakeholders, the resulting decisions might well be expected to be controversial. In this section we review the reasons that conversion specialists, converting institutions, and critics of conversions give for credit unions to convert.

Conversion specialists and converting credit unions commonly cite the following advantages of mutual thrift charters over credit union charters: (1) absence of a field of membership that restricts growth of depositors and borrowers and reduces the risks of having a single employee group or geographic area, (2) more generous limits on investment and lending powers (e.g., business lending, commercial real estate, corporate bonds), (3) better ability to diversify lending portfolios outside of the highly competitive auto and consumer lending markets, (4) greater scope for compensating directors financially and attracting higher-quality directors who might exert more effort to monitor management, (5) avoiding having to deposit one percent of insured shares in NCUSIF and, currently for nearly all FDIC-insured institutions, not having to pay insurance premiums at all, (6) lower effective capital requirements and greater flexibility in raising capital quickly (e.g., via issuing subordinated debt), and (7) greater ability to convert further (to stock thrifts and commercial banks) and thereby

further ease capital raising (e.g., via common stock), which may in turn permit compensation programs that better align incentives, not only of managers, but also of directors (Luse 1997a: 11, Malizia 1998, Theriault 2000b:1-5, KBW 2001: 4, 34, 55, Causey 2004: 5, and Morrison 2004a and 2004e).¹⁴

Conversion specialists note the following actual and potential disadvantages of credit unions converting to mutual thrifts: (1) losing corporate income tax exemptions, (2) becoming subject to the Community Reinvestment Act, (3) needing to readjust one's portfolio to meet the qualified thrift lender test (e.g., reducing consumer loans and increasing mortgage loans), and (4) having to increase managers and directors' compensation (Luse 1997a: 11, Malizia 1998, and Theriault 2000b:1-3).

Conversion specialists and converting credit unions point out that conversions can access some advantages without foregoing all of the advantages of mutual (or cooperative) ownership. They argue that there are many relevant similarities between credit unions and thrifts. For instance, thrifts can operate as mutuals and can choose to have a "one member, one vote" voting mechanism (e.g., Citizens Community). Further, the activities and attitudes of many mutual thrifts are often not so different from those of credit unions: They both often choose to concentrate their lending in residential real estate, consumer, and educational loans; make few commercial loans; emphasize community and philanthropic activities; and often target a niche group of customers (Malizia 1998, Theriault 2000b: 4, and CUNA 2001).

Conversion specialists, converting institutions, academics, and regulators generally cite the following advantages of stock thrifts over mutual thrifts: (1) greater ability to raise capital (e.g., via issuing additional shares of stock) to meet capital requirements, (2) greater ability to raise capital to finance growth, (3) greater ability to use shares of stock in compensation programs for employees, managers, and directors (via stock options, stock grants, and employee stock ownership plans) so that their interests are better aligned with those of shareholders, and to better attract and retain personnel, (4) greater ability to use stock to provide opportunities for capital appreciation to members that purchased stock, (5) greater flexibility to grow through acquisitions and mergers with other stock financial institutions (although no longer

¹⁴ The (since abandoned) Conversion Plan for Columbia Community Credit Union includes a standard presentation of the reasons to convert provided by converting credit unions and conversion specialists. See <http://saveccu.com/archives/CCUsPlanOfConversion.pdf>.

with mutual institutions), and (6) greater organizational flexibility to establish holding companies and subsidiaries (OTS 1994a: 3, Eccles and O’Keefe 1995: 5, Luse 1997a: 11, Colantuoni 1999:1, KBW 2001: 4, 34, 55, Morrison 2004c and 2004d, Ryan Beck 2005, and Theriault 2005).

Conversion specialists highlight capital pressures as one of the main reasons to convert. They argue that credit unions with growth opportunities may find that credit union net worth requirements prevent them from acquiring and serving more depositors and borrowers. Since retained earnings are effectively the only source of capital for meeting net worth requirements, growing credit unions often face the choice of whether to forego growth or forego their credit union charters. The management of the former Allied Pilots Association FCU argues that their institution serves as an example of such a choice. Assets in their institution grew from \$43 million in 1996 to \$72 million in 1998. To abide by newly-introduced net worth requirements, the credit union restricted its average growth rate to under three percent in 1999-2000. By December 31, 2000, immediately before its conversion, the institution still had a net worth ratio of only 5.16 percent (Theriault 2000a: 2, KBW 2001: 4, 34, 55, Reosti 2002, Bettis 2003, and CUNA 2005a).

Conversion specialists trumpet the mutual holding company (MHC) structure as a way to retain mutuality and attain stock ownership. Under this structure, (1) members retain legal control of the institution; (2) managers are somewhat insulated from stockholder pressures; (3) the MHC may acquire both stock and mutual institutions and keep them as separate subsidiaries; (4) the MHC may raise capital via issuing new stock to finance faster growth; and (5) the MHC may use stock in managerial and employee benefit plans (Luse 1997b, Smith 1999a: 8, Bettis 2003, Morrison 2004d, and Ryan Beck 2004: 71-72).

OTS rules require thrifts engaging in standard mutual-to-stock conversions to raise capital equal to the institutions’ estimated fair market values. The resulting capital infusions mean that many converted thrifts find themselves flush with capital. Converted thrifts might well find it difficult to rapidly and effectively deploy so much more capital. In contrast, MHCs may raise capital more gradually. They can issue new capital in steps, until they have sold 49 percent of the stock of the stock company subsidiary. Some mutual thrifts may go through first-step conversions, with being MHCs as their ultimate structure, with the goals of retaining mutuality and attaining access to capital via selling shares of stock that have effectively-limited voting rights. However, many other mutual thrifts engage in first-step conversions

as an intermediate step, one that allows them to raise capital in steps while they are MHCs, toward their longer-term goal of converting to a completely stock structure (Smith and Underwood 1997: 41, Smith 1999a: 8, Ryan Beck 2004: 71-72, and Luse and Gorman 2005: 10).

The disadvantages of mutual-to-stock conversions (in either the standard format or by steps) are likely to be distributed unevenly. In exchange for their greater compensation, managers (1) likely will come under somewhat increased scrutiny by analysts and institutional stockholders, (2) may feel pressured to increase risk-taking in order to restore percentage returns on equity, which can be depressed by the initial surge in capital, and (3) may lose some of the control of the organizations that they had when they were mutuals, especially if their stock prices indicate poor performance (Eccles and O'Keefe 1995: 6, Smith and Underwood 1997: 31, Ryan Beck 2005, and Theriault 2005).

Further, some non-buying members may realize that their claims on retained earnings were transferred to buying members and external investors. And former members who are current customers may find that the former credit union has realigned its lending (e.g., toward business lending or toward more scoring) and raised lending rates and fees to the benefit of stockholders and the expense of current customers. While managerial and employee stock benefit plans may better align the interests of managers and stockholders, these plans are also likely to increase noninterest expenses (KBW 2004: 45).

Critics of conversions of credit unions into mutual thrifts and of further conversions by former credit unions often highlight the potential conflicts of interest that various groups of stakeholders face. They note that managers and directors of credit unions and other mutuals advocate conversions in order to (1) avail themselves of the opportunities to accrue the claims on retained earnings that non-buying members surrender and (2) to award themselves generous stock-related compensation packages¹⁵ (Colantuoni 1999: 3, Schiff 2003, Chaddad and Cook 2004: 577, and NASCUS 2005). Further, critics point out that conversions rarely if ever are initiated by members. Instead, they seem to arise following prodding by conversion specialists who “sell the idea” to the managers and directors of credit unions (and other cooperatives

¹⁵ For instance, Rainier Pacific, a former credit union with \$33 million in net worth before converting decided to award its officers \$2 million in stock grants and \$6.8 million in stock options over 5 years (CU Journal 2005f). Atlantic Coast Federal, with \$28 million in net worth before converting decided to award its managers and directors over \$5 million in stock grants and options (CU Journal 2005e).

and mutuals) (Morrison 2004b and 2004c). Conversion specialists Bert Ely and Alan Theriault respectively describe conversions as follows: “It really was a no-brainer. You had all this money sitting there without anyone’s name on it” and “If the conversion is not made during the current tenure, the next CEO in charge may very well realize the value” (Morrison 2004b and Theriault 2005).

D. DO MEMBERS BENEFIT FROM CONVERSIONS?

In this section, we present a conceptual approach to help gauge whether and when members benefit from conversions. The approach simplifies some aspects of credit unions in order to highlight some of the issues at hand. Essentially, credit union members benefit from belonging but sacrifice the benefits of owning. Conversion removes the former and undoes the latter.

The approach takes into account some (but not all) of the avenues through which members benefit from ownership of mutuals that we noted in section IV A. For example, we do not include the effects that would be associated with any easier access to lending, with access to financial services that are provided with below-market fees, or the value of nonpecuniary benefits, such as those that might be associated with belonging to a mutual. Again, to simplify, we abstract from the riskiness of each of the benefits and costs and from any tax-related effects. The approach then focuses primarily on the quite direct, net, pecuniary benefits of credit unions.

We assume that credit union members pay lower loan rates and get higher savings rates than are available at stock depositories. Given the current state of legislation and regulation, members of credit unions forego individual rights to transfer, sell, or access their *pro rata* share of the institution’s retained earnings. Put differently, if a credit union converted (perhaps, after several steps) to a stock entity, (some or all) members (1) could gain access to their *pro rata* share of retained earnings, but (2) would likely forego future lower loan rates and higher savings rates. Our approach then compares the present discounted value of member benefits with the present discounted value of the foregone opportunity to access members’ *pro rata* shares of retained earnings.

Consider a credit union with \$100 million in its only assets, loans, \$90 million in savings, \$10 million in retained earnings, and 10,000 members each with loans worth \$10,000, savings worth \$9,000, and a *pro rata* share of retained earnings worth \$1,000. Suppose that the

credit union charges its members 0.50 percent (in annual all-in interest, fees, and other aspects of loans) less on comparable loans and pays its members 0.50 percent more on comparable savings than other stock depositories. Then, each member will receive annual borrower benefits of $(\$10,000 * 0.50 \text{ percent} =) \50 and annual saver benefits of $(\$9,000 * 0.50 \text{ percent} =) \45 , for a total annual member benefit of \$95.

If they could invest their funds at (an annual interest rate of) 9.5 percent, then members would be indifferent (again purely on pecuniary grounds) between having the right to liquidate their *pro rata* share of retained earnings (\$1,000) and receiving their annual benefits indefinitely (\$95 per year). (See equations 1 and 2 below). If they could invest at rates above 9.5 percent, then the average member profiled above would be better off with access to the retained earnings than with access to the interest rate differentials. If higher rate differentials were available, they would benefit more by retaining and belonging to the credit union than by converting it to a stock company. Equations (1) and (2) present the calculation that we described above:

(1) Value (of the retained earnings) = annual benefits (in dollars) / rate of return (percent)

(2) \$1000 = \$95 / 9.5 percent

In equation (2), the breakeven rate of return of 9.5 percent is the rate that equates the present values of the benefits of the two structures, mutual and stock. Table 5 displays similarly-calculated breakeven rates of return for various capital, or net worth, ratios and annual member benefits. Here, annual member benefits are expressed in percent, as the sum of (1) the percent by which interest rates for comparable loans in a credit union are lower than at stock depositories and (2) the percent by which interest rates for comparable savings products in a credit union

are higher than at stock depositories. To calculate the breakeven rates in Table 5, we supposed that the total interest rate benefit is split evenly between borrowers and savers).¹⁶

Table 5: Rates of return above which average members benefit from conversions

| | | Annual member benefits (%) | | | |
|---------------------|----|----------------------------|------|------|---|
| | | 1 | 0.5 | 0.1 | 0 |
| Net Worth Ratio (%) | 5 | 19.50 | 9.75 | 1.95 | 0 |
| | 10 | 9.50 | 4.75 | 0.95 | 0 |
| Ratio (%) | 15 | 6.17 | 3.08 | 0.62 | 0 |
| | 20 | 4.50 | 2.25 | 0.45 | 0 |

Note: Annual member benefits (percent) in this approach are calculated as the sum of (1) the percent by which interest rates for comparable loans in a credit union are lower than at stock depositories and (2) the percent by which interest rates for comparable savings products in a credit union are higher than at stock depositories.

This approach implies that members (with the average member profile in their own credit unions) of credit unions that have lower net worth ratios and higher member benefits (e.g., 5 and 1 percent respectively) would be better off by accessing their (*pro rata* shares of) retained earnings only if rates of return that they could earn on their assets were extremely high (i.e., 19.5 percent). By contrast, average members of credit unions that have higher net worth ratios and lower member benefits (e.g., 15 and 0.1 percent respectively) would be better off accessing their retained earnings even if rates of return were very low (i.e., rates as low as 0.62 percent). In the extreme case where credit unions provide their members with no borrowing or savings rates advantages, member benefits are nil, and average members would be better off accessing retained earnings at any rate of return.

There are practical difficulties in measuring member benefits precisely at individual credit unions. At the same time, the variance across credit

¹⁶ Applying this approach may be difficult in practice since individual credit unions and stock depositories do not necessarily disclose detailed information on interest rates charged and paid and volumes involved in different loan and deposit products for members and customers with different risk levels. Comparing aggregate loan rates and aggregate deposit rates across individual depositories might produce biased results. Consider the following two credit unions. The first credit union specializes in providing typically high-risk, high-rate loans at lower rates (e.g., benefiting member consumers by providing them consumer loans at, for instance, 9 percent at a deep discount of 3 percent relative to the 12 percent available elsewhere). The second credit union specializes in providing lower-risk, lower-rate loans at standard rates (e.g., providing next to no benefit to member homeowners by providing them home equity loans at, for instance, the same 5 percent available elsewhere). If one did not take into account the types of loans made and simply compared the aggregate loan rates for each credit union, one might conclude incorrectly that the second credit union was generating larger member benefits.

unions in their net worth, interest income, and interest expense ratios is very large (see Wilcox 2005). This suggests that table 5 will provide a valuable frame of reference for credit unions that want to assess how much net benefit they provide to members.

Of course, this approach does not imply that conversions are the only route through which credit unions with high net worth ratios and low member benefits can or should provide value to their members. Rather, to boost their net benefits, credit unions might (1) voluntarily distribute a portion of their retained earnings to their members directly or (2) lower their loan interest rates and raise their savings interest rates, which would serve to distribute retained earnings to their members indirectly.

This approach could be enhanced by making some of its simplifying assumptions more realistic. The simple approach above assumes that (1) the credit union splits member benefits evenly between borrowers and savers, (2) all members have identical borrowings and savings, (3) members buy stock, or receive claims on retained earnings, *pro rata* to their savings, and (4) the value of annual benefits received by members would not increase over time.¹⁷ The internal borrower-saver conflicts and politics in each credit union, the conversion methodology employed, and the amount of stock purchased (or received) by each member would each affect the precise distribution of value received (1) by member-savers versus member-borrowers and (2) by non-buying members versus buying members and external investors, if a credit union survives or converts. (Section IV B detailed how if some individual members buy (or receive) less than their *pro rata* share of retained earnings, their claims on value are transferred to other members and/or to external investors.)

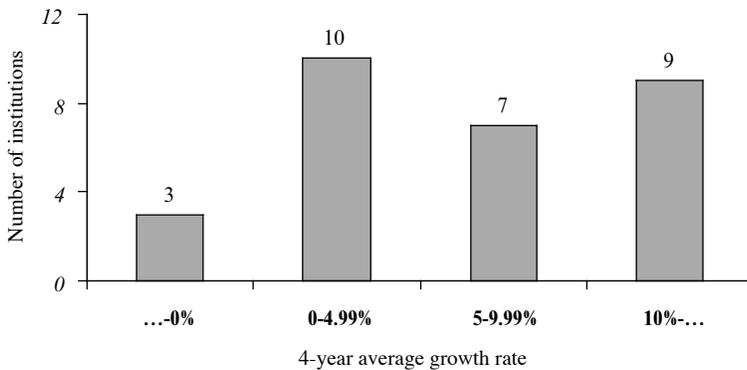
¹⁷ If one assumes that member benefits (related to the volumes of loans and savings) will grow over time in line with asset growth and that asset growth rates will be constant or broadly predictable, the “no-growth common stock dividend valuation model” used above could be readily substituted by the “constant growth dividend valuation model” (Gallagher and Andrew 2000: 219) which includes a term for growth in stock dividends (or here member benefits). Adapted for these purposes, the approach would become: (3) Value (of the retained earnings) = annual benefits (in dollars) / (rate of return – growth in assets (or benefits)). At higher asset growth rates, conversions (or accessing retained earnings) would require higher risk-adjusted rates of return (i.e., conversions would be less likely to benefit average members).

E. CHARACTERISTICS OF CONVERTING AND NON-CONVERTING CREDIT UNIONS

To help us better understand which credit unions are more likely to convert and why, this section presents, compares, and analyzes financial data for the characteristics of converting credit unions and of samples of non-converting credit unions.

Figure 5 displays the numbers of credit unions, sorted by their 4-year-average asset growth rates prior to their conversions¹⁸ (i.e., very high growth: 10 percent and higher, high growth: 5-9.99 percent, low growth 0-4.99 percent, and negative growth: under 0 percent). Many of the converting credit unions experienced very high (9 credit unions) or high (7) asset growth in the years just prior to conversion. Nonetheless, unusually rapid growth was not characteristic of most converting credit unions. For example, the asset growth rates of the remaining 13 converting credit unions were no higher than that of nominal GDP over the same periods.

Figure 5: Number of converting credit unions by 4-year average asset growth rate ranges (1995 – January 2006)



Source: NCUA call reports 1990-2004.

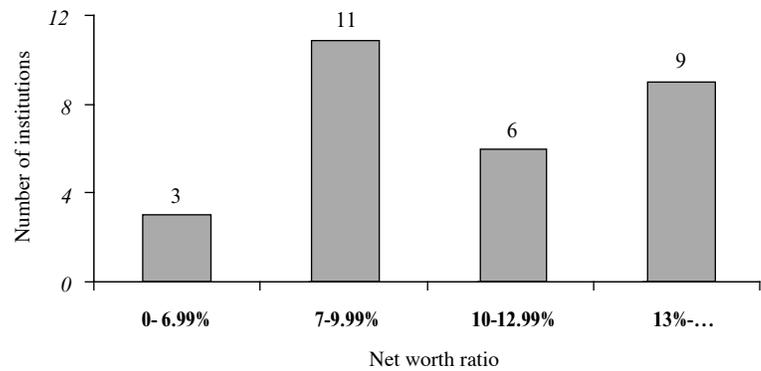
Figure 6 displays the numbers of credit unions, sorted by their capital, or net worth, ratio on the December 31 immediately prior to their conversions¹⁹ (i.e., very high net worth ratios: 13 percent and higher, high net worth ratios: 10-12.99 percent, net worth ratios somewhat close to the lower limit for well capitalized credit unions: 7-9.99 percent,

¹⁸ For the credit unions converting in January 2006, we used average growth rates between December 31, 2000 and December 31, 2004.

¹⁹ For the credit unions converting in January 2006, we used net worth ratios as of December 31, 2004.

and below well capitalized: under 7 percent). While some converting credit unions had net worth ratios that classified them as less than well capitalized (3 credit unions) or somewhat close to the regulatory boundary for that classification (11), many converting credit unions had high (6) or very high (9) net worth ratios. Thus, figures 5 and 6 suggest that past fast asset growth and low net worth ratios are unlikely to be the only motivations for conversions.

Figure 6: Number of converting credit unions across different net worth ratio ranges (1995 – January 2006)



Source: NCUA call reports 1994-2004.

Table 6 provides comparisons of numerous financial characteristics for samples of credit unions that converted and those that did not convert. Column 1 provides data averaged over all credit unions that converted between 1995 and January 2006. Unless stated otherwise, the data in this table is as of the December 31 prior to each conversion. Average characteristics of credit unions tend to vary widely across asset sizes (Wilcox 2005). Thus, table 6 provides comparison data for converting and non-converting credit unions of various asset size categories: all, medium, large, and very large. Columns 2 and 3 compare average data for converting and non-converting medium-sized credit unions (with between \$10 and \$100 million in assets) in 1995-2004. Columns 4 and 5 compare average data for converting and non-converting large credit unions (with between \$100 million and \$1 billion in assets) in 1995-2004. Since no credit unions with under \$1 billion in assets converted during 2005 and January 2006, we restricted the samples in columns 2-5 to 1995-2004. Since no credit unions with over \$1 billion in assets converted before 2006, columns 6 and 7 compare average data for converting and non-converting credit unions that had between between

\$1 billion and \$2 billion in assets as of the most recent December 31 for which data were available (i.e., 2004).

Table 6: Financial characteristics of converting and non-converting federally-insured credit unions (FICUs) (1995-January 2006)

| | All converting FICUs (1) | Medium FICUs (\$10-100m) 1995-2004 | | Large FICUs (\$100m-1b) 1995-2004 | | Very large FICUs (\$1-2b) January 2006 | |
|--|--------------------------|------------------------------------|--------------------|-----------------------------------|--------------------|--|--------------------|
| | | Converting (2) | Non-converting (3) | Converting (4) | Non-converting (5) | Converting (6) | Non-converting (7) |
| (1) Number of credit unions converting | 29 | 9 | - | 13 | - | 2 | - |
| (2) Number of credit unions in 2004 | - | - | 3,605 | - | 1,057 | - | 71 |
| (3) Average asset size (\$ million) | 198 | 46 | 32 | 209 | 258 | 1,282 | 1,341 |
| (4) 4-prior years' asset growth (%) | 10.6 | 8.1 | 2.7 | 7.7 | 9.6 | 15.0 | 22.1 |
| (5) Net worth (%) | 9.2 | 10.6 | 11.3 | 10.1 | 10.7 | 7.8 | 10.4 |
| (6) Net loans (%) | 74.3 | 68.4 | 62.8 | 77.6 | 63.8 | 72.4 | 64.7 |
| (7) Member business loans (%) | 4.69 | 3.26 | 0.61 | 5.15 | 1.22 | 4.53 | 1.60 |
| (8) Real estate loans (%) | 32.1 | 32.7 | 19.8 | 41.1 | 26.5 | 22.5 | 31.8 |
| (9) ROA (%) | 0.83 | 1.39 | 0.88 | 0.87 | 1.01 | 0.70 | 1.03 |
| (10) Interest spread (%) | 3.56 | 3.93 | 3.94 | 4.02 | 3.56 | 3.00 | 2.98 |
| (11) Interest income (%) | 5.98 | 6.85 | 6.83 | 7.28 | 6.47 | 4.47 | 4.44 |
| (12) Interest expenses (%) | 2.43 | 2.93 | 2.88 | 3.25 | 2.91 | 1.48 | 1.46 |
| (13) Noninterest expenses (%) | 3.59 | 3.90 | 3.58 | 3.64 | 3.18 | 3.48 | 2.80 |
| (14) Delinquent loans (%) | 0.42 | 0.45 | 0.69 | 0.49 | 0.45 | 0.34 | 0.36 |
| (15) Loan Loss Provisions (%) | 0.48 | 0.44 | 0.31 | 0.53 | 0.34 | 0.45 | 0.33 |
| (16) Net charge-offs (%) | 0.43 | 0.40 | 0.30 | 0.40 | 0.31 | 0.46 | 0.32 |

Sources: NCUA call reports for 1990-2004.

Note: All values in rows 4-16 are expressed as a percent of assets. This table includes data for both credit union conversions and merger-conversions. Data for credit unions converting in January 2006 (column 6) are as of December 31, 2004. Thus, the data for credit unions not converting in January 2006 (column 7) is also as of December 31, 2004.

Compared with non-converting credit unions, converting credit unions tended to have lower net worth ratios, were substantially more loaned up, had more member business loans, paid and charged slightly more in interest to members, and had higher noninterest expenses, loan

loss provisions, and net charge-offs. Several other characteristics (including average growth rates over the four years prior to conversion, ROA, interest spreads, and real estate lending) were either similar across converting and non-converting credit unions or did not exhibit consistent patterns across different asset sizes.

Table 6 enables us to see whether averages of individual characteristics of converting credit unions differed from those of non-converting credit unions. To begin investigation of whether more complex or subtle differences lie beneath the surface, we also performed a variety of multivariate statistical tests and regressions. To estimate whether the converting credit unions as a group differed from non-converting credit unions, we estimated the effects of many of those same characteristics on the tendencies to convert using the methods of matched logit, matched probit, matched ordinary least squares, and matched ordinary least squares weighted by assets. Following standard methodology in matched-sample regressions, we collected a sample of 29 non-converting credit unions that “matched” the 29 converting credit unions. To be a match to a converting credit union, a non-converting credit union had to be from the same state and have had the closest asset size. (Data for each converting and matched non-converting credit union were for the most recent December 31 prior to conversion for which data was available). We experimented with a variety of functional forms, combinations of variables, and data sets, and found results to be robust across specifications.

Table 7 presents the results for a representative logit regression that was based on a sample that included the 24 converting credit unions that had more than \$10 million in assets and their 24, matched, non-converting credit unions.

**Table 7: Results for a matched-sample logit regression
(1995-January 2006)**

| Variable name | Coefficient (t-statistic) |
|---------------------------|------------------------------|
| Constant | -8.57 (-1.51) |
| Assets (\$ billion) | 0.87 (0.49) |
| 4-year average growth | 0.001 (0.01) |
| Net worth (%) | -0.10 (-0.52) |
| 4-year average ROA | 4.14 (2.20)** |
| Noninterest expenses (%) | 0.72 (0.82) |
| Member business loans (%) | -0.06 (-1.19) |
| Real estate loans (%) | 0.11 (2.83)*** |
| Net charge-offs (%) | 4.28 (1.74)* |
| Interest received (%) | -0.97 (-0.72) |
| Interest paid (%) | 1.58 (1.08) |

R-square = 0.38

Fraction of correct predictions = 0.79

Notes: Variables followed by the percent sign are expressed as a percent of assets. *, **, and *** represent significance at the 10, 5, and 1 percent levels.

The results shown in table 7 suggest that credit unions that have higher earnings (i.e., with higher ROAs), with greater shares of assets in real estate loans (i.e., more similar to typical thrifts), and higher net loan charge-offs (i.e., engaging in riskier lending) are more likely to engage in conversions. The results also imply that, in general, asset growth rates, net worth, noninterest expenses, business lending, interest income, and interest expenses were not significant predictors of credit union conversions.

However, to date, the predictive ability of these estimates may be limited. So far, the number of credit union conversions has hardly been large enough either to apply sophisticated statistical analysis techniques or to study different subsets of converting credit unions separately. Whether the small number of credit union conversions observed so far are representative of what credit unions are likely to convert remains to be seen. For example, in contrast to the patterns observed so far, some low-capital credit unions might convert to improve their access

to capital, while some high-capital credit unions might convert so that they can distribute retained earnings. At this point, our results simply indicate that, in general, net worth ratios have not been a significant predictor of credit union conversions.²⁰

²⁰ Statistical regressions including both net worth ratios and their squares did not find either variable to be statistically significant.

SECTION V: Potential Reforms Of Conversion Policies

Section V A reviews public policies regarding conversion of mutual depositories, with a focus on voting requirements and their regulatory enforcement. Section V B presents proposals for reforming conversion rights that would recognize both the saving and borrowing histories of the members as well as their current positions. Section V C reviews demutualization in insurance companies and depositories in the US and in other countries. The section concludes with a set of proposals for and issues regarding allowing credit unions to use a similar conversion method.

A. VOTING THRESHOLDS AND REGULATORY ENFORCEMENT

This section reviews potential reforms of the public policy toward conversions that focus on voting requirements. Some critics of conversions propose implementing more strict voting thresholds for conversion votes than those that are currently in place. In the extreme, these proposals would involve either (1) forbidding indefinitely conversions of federally-insured credit unions (as some states do for state credit unions), (2) introducing moratoria for new conversions until the issues are studied in further detail by *ad hoc* commissions and/or legislatures (a method used by the federal government in the past when thrifts were troubled), or (3) reintroducing the requirement that half of eligible voters (rather than of votes cast) approve conversions (as in mutual-to-stock thrift conversions). However, congressional votes over the last few years indicate that it is unlikely that any of these stricter proposals would become law in the near term.

Others propose partial reforms of conversion vote regulations. For instance, section 310 of House of Representatives (H.R.) bill 2317, the Credit Union Regulatory Improvements Act (CURIA) of 2005, proposed changing the requirement for a conversion from a majority of voters to a majority vote of at least 20 percent of the membership (CUNA 2005h). Alternatively, critics of conversions might favor adding a federal requirement of having a super-majority of voting members (similar to the requirement of two thirds of voting members in credit union-to-mutual thrift conversions in some states or as high as three quarters of voting members in some mutual-to-stock insurance company conversions) (NAMIC 1999: 1).

Still others advocate more strict enforcement of existing legislation and regulations. They also advocate more restrictive regulation by the

NCUA. For instance, the NCUA found a series of violations in the voting procedures applied in a conversion attempt by Columbia Community Credit Union (CCCU) in 2003. Several of the violations resulted from having invoked a federal parity provision under Washington state law. CCCU sought to reduce the requirement for conversion from two thirds of voting members under state law to 50 percent of voting members under federal law.

However, the NCUA ruled that if the lower federal voting threshold applied, what also applied were the federal provisions under which members retained their membership unless they withdrew or were expelled. In particular, because CCCU membership application cards until 1995 referred to the multiple signers of joint accounts as members, the NCUA argued that CCCU should have sent a separate conversion ballot to each signer. The NCUA ruled that the conversion could not proceed unless a second (corrected) vote took place (Love 2004). Following bruising controversies and legal actions between management and members, CCCU abandoned its conversion attempt.

Ever stricter enforcement of conversion regulations might trigger a congressional backlash against the regulatory authority that Congress has delegated to the NCUA. Conversion attempts in 2005 by Community Credit Union (CCU) and OmniAmerican Credit Union, both located in Texas, might be instructive. Arguing that these credit unions ignored oral instructions that required them to present NCUA-approved disclosures before any rebuttals to the disclosures, the NCUA disagreed with the Texas Credit Union Department, the FDIC, and the OTS and announced its intention to disapprove their conversion votes.²¹ CCU argued (1) that the rebuttals appeared prior to the required disclosures due to the misfolding of a page (i.e., the disclosures were on one side and the rebuttals on the other) and (2) that the NCUA's decision was "based on a hypertechnical interpretation of their regulation" (CUNA 2005c and 2005d).

In the litigation that ensued, US Magistrate Donald Bush ruled that the NCUA had not proved that CCU had agreed to those oral instructions and stated that "there's nothing in the regulation that sets the order of submission of the documents." On August 30, 2005 the NCUA settled the case and agreed to approve both member votes (CU Journal 2005m and 2005n). The two credit unions finalized their conversions on January 2, 2006.

²¹ The cost of eventually reprinting and mailing CCU's disclosure documents for a second conversion attempt was estimated at \$650,000 (CUNA 2005c).

Despite the settlement, these disputes attracted the attention of other federal regulators and Congress. Richard Riccobono, acting director of the OTS, argued that NCUA voting requirements have made the conversion process burdensome. US Representative Brad Sherman (a Democrat from California and an ongoing credit union supporter) argued that the NCUA overreacted on what he saw as a technicality. US Representative Patrick McHenry (Republican, North Carolina) called the NCUA's action "re-freaking-diculous" and a case of bureaucratic bungling and excessive regulation. Mr. McHenry also announced his intention to submit legislation to restrict the ability of the NCUA to invalidate conversion votes (CU Journal 2005h and CUNA 2005e). Hearings into conversions may well result.

B. CONVERSION RIGHTS REFLECTING INDIVIDUAL HISTORIES OF SAVING AND BORROWING

Member rights in mutual-to-stock thrift conversions have typically been based on deposit balances as of an eligibility date under both the free distribution model (strongly) and under the standard conversion method (weakly, see section IV B). Using deposit balances as of an eligibility date to determine rights in conversions certainly are likely to lead to disparities. Depositors who contributed to retained earnings over extended periods of time but who withdrew their deposits just before the eligibility date would receive no conversion rights. Also, long-term depositors would receive no more rights to the retained earnings that they helped to build than recent depositors, even those who made deposits one day prior to the eligibility date.

Regulators, consulting firms, several publications, and other observers have long recognized that a class of "professional depositors" or "flippers" make deposits in mutuals in anticipation of upcoming conversions. These depositors seek conversion-related "pops" on the shares that their last-minute deposits entitle them to. Often such depositors then withdraw shortly after conversions, presumably in order to fund new deposits at other anticipated conversions. For instance, SNL of Charlottesville, Virginia, sponsors a variety of publications and services dedicated to advertising (1) the potential gains to external investors from mutual thrift conversion IPOs, (2) the remaining mutuals who accept out-of-state deposits by mail, (3) the mutuals thought most likely to convert in the near future, and (4) the potential gains to external investors from credit union conversions. Recently, Atlantic Coast, a former credit union with under \$400

million in assets before converting into a mutual thrift, received almost \$100 million in additional deposits during the quarter prior to its stock offering (OTS 1994b: 13, SNL 1999: 3 and 2005, and CU Journal 2004a).

Why would such an eligibility date exist? In the distant past, several state courts upheld dividing an institution's retained earnings at liquidation *pro rata* to members' deposits as of an eligibility date (*Morristown Institution for Savings v. Roberts*, Rhode Island 1887) and rejected proposals to factor the length of time funds had been on deposit (*In re Cleveland Savings Society*, Ohio 1961). However, courts also explicitly recognized that this approach was not equitable, but essentially the least egregious solution. For instance, in 1903 a New Jersey court ruled as follows (Smith and Underwood 1997: 12- 13):

There is indeed no known mode of dividing a surplus of a savings bank, when such division becomes necessary, except among the *bona fide* depositors at the time of the dissolution. But it does not follow that such division is just and equitable. It is a rule of convenience and necessity, not of equity. Consider, in that connection, the temptation of eleventh-hour people to come in as depositors in anticipation of dissolution.

These court rulings, however, (1) simply upheld the validity of *pro rata* distributions based on an eligibility date, (2) were made before the widespread development of modern computing technologies,²² and (3) do not prevent legislators, regulators, and individual charters from experimenting with different calculation methods.²³ With the advent of computing capabilities that may routinely and automatedly reckon daily, monthly, and annual average deposits for individual members; legislators, regulators, and individual institutions should seriously consider conversion rights that take more into account each member's deposit history.

In the extreme, this approach would greatly diminish, if not almost completely eliminate, the current incentives to make last-minute deposits. Consider two depositors. The first depositor holds an average of \$10,000 in deposits for over 28 years. The second depositor holds \$10,000 in deposits only for one day before the eligibility date. Under

²² For instance, personal calculators did not become widespread until the 1970s and personal computers with spreadsheet tools did not become widespread until the 1980s.

²³ In some states, former members of mutual insurance companies may receive conversion rights (NAMIC 1999: 1).

current regulations, both depositors have rights to purchase equal amounts of stock in a conversion. Meanwhile, the first depositor participated in the credit union for 10,000 times as long as the second depositor participated.

Basing conversion rights on the entire length of deposits may not be implemented readily. Practical problems include: (1) institutions are unlikely to have computerized deposit records for periods before they started using computers and (2) some computing systems may not be designed to retain or access individual historical deposit data on a large-scale basis.

However, almost any use (or shift toward the use) of the length of deposits would lead to fewer disparities than the current system. Legislators, regulators, and individual institutions could consider several approaches to introducing the partial use of the length of deposits in the calculation of member conversion rights. Member conversion rights could be based on (1) average deposits for a time period beginning on the first date on which computerized records may be readily accessed as determined by an independent party, (2) deposits on December 31 of each year, beginning on the first date on which computerized records may be readily accessed as determined by an independent party, (3) average deposits for only the previous five, ten, or fifteen years, or (4) average deposits beginning only after some related announcement is made (included in a change in legislation, regulation, or an amendment to the institution's charter as approved by its members).

Other potential reforms could shift conversion rights toward each member's history of contributions to the retained earnings of the institution. These changes could be made through legislation or regulation for all federal, federally-insured, or state institutions with a certain charter. Alternatively, regulators could permit individual institutions and their members to determine which method best suits them and to implement it through amendments to their charters. Institutions could use the sum of interest received rather than average deposits to calculate member conversion rights. The sum of interest received per member is likely to be easier to calculate than historical average deposits. Interest received might also better reflect the different contributions to retained earnings of various types of deposits if longer-term, higher-rate deposits give institutions more flexibility managing interest-rate and maturity risks. Further, institutions could

adjust the value of historical deposits (or interest) to take into account inflation, using a recognized measure of inflation such as the Consumer Price Index computed by the Bureau of Labor and Statistics.

Institutions that base voting rights on both deposit and loan balances might consider basing conversion rights not only on the volume and length of deposits (that reflect members providing funds on which some earnings are not paid but are retained) but also on the volume and length of loans (that reflect members providing the earnings that the institution retained). Institutions that do not base voting rights on loan balances could also consider recognizing the contributions of borrowers and grant them conversion rights. Whether deposits and loans should receive the same weight in the calculation of member conversion rights could also be determined by individual institutions.

C. DEMUTUALIZATION

This section (1) presents the demutualization model (broadly similar to the free distribution model) of mutual-to-stock conversions in insurance companies and depositories in the US and other countries, (2) reviews ongoing proposals for thrift demutualizations and cash-out options for dissenting members in mutual-to-stock thrift conversions, (3) discusses advantages, disadvantages, and criticisms of the demutualization model, and (4) presents a set of proposals for a version of the demutualization model for credit unions that wish to convert eventually into the stock form.

Over the past few decades, mutual depositories and mutual insurance companies have converted to the stock form in the United States, Britain, Australia, Canada, and South Africa (Swiss Re 1999: 3 and Chaddad and Cook 2004: 576). The conversion methods used today and historically, both in depositories and in other industries, and in the US and in other countries, can provide insight about credit union and other conversions. The experiences of other industries and countries may help to answer some questions about the relative advantages and disadvantages of the standard conversion method available under OTS (and FDIC) rules and other methods.

Under the demutualization model, in exchange for extinguishing their joint claims on the retained earnings of a mutual institution,

members do not receive the right to participate in a stock offering, but tangible compensation. The details of how the demutualization model is implemented can vary widely. We describe some of the conversion methods used by recounting over 50 conversions of mutual insurance companies in the US during the 1990s²⁴ and 10 conversions of building societies (i.e., depositories) in Britain between 1989 and 2004 (Chaddad and Cook 2004: 581 and Shiwakoti et al. 2004: 6). Insurance companies in the US are largely regulated at the state level. As a result, legislation and regulation for mutual-to-stock insurance company conversions can and does vary widely across states. (Often the conversions of individual companies are regulated by specific state legislation).²⁵

In insurance company conversions that use the demutualization model (i.e., demutualizations), members receive the retained earnings in the company in the form, not of rights or options as in the standard conversion of mutual thrifts now in the US but, of shares of stock, cash, policy credits, or some combination thereof.²⁶ In and of itself, this step does not raise new capital for the converting company. In fact, it may reduce capital, due to the costs of the conversion (legal, printing, etc.) and to the cash distributions to members (NAMIC 1999: 1, Smith 1999b: 28, Swiss Re 1999: 26, Daily 2000: 5, and SNL 2005).

However, demutualizations may also combine with initial public offerings (IPOs) of new shares, which raise additional capital for the company. In some demutualizations, members have preferential rights to purchase additional shares of stock and external investors may purchase stock only if members do not buy all of the available shares. In other demutualizations, members largely receive their shares of retained earnings in the form of cash and are not allowed to buy stock. In recent years, over 20 states have also passed legislation that permits mutual insurance companies to convert using variants of the standard conversion method (NAMIC 1999: 1, Smith 1999b: 28-29 and 31, Swiss Re 1999: 26, Daily 2000: 5, and SNL 2005).

²⁴ The Prudential and Metropolitan Life insurance companies have completed a full circle of stock-to-mutual and mutual-to-stock conversions.

²⁵ Mutual insurance companies in the United States date back to the Philadelphia Contributorship for the Insurance of Houses from Loss by Fire founded by Benjamin Franklin in 1752, and thus count among the oldest companies in US territory (NAMIC 1999: 7).

²⁶ Some members with very small *pro rata* shares of retained earnings may prefer cash payments. Other members may prefer the certainty of a fixed cash payment at the time of an IPO to the risks involved in stock ownership. Yet, other members who previously did not own stocks may simply not want to undergo the financial and time costs of opening and managing a small brokerage account. Some members may prefer policy credits to avoid the possible tax consequences of receiving stock or cash distributions.

The demutualizations of building societies in Britain (analogous to thrifts in the US) differed substantially both from standard IPOs and from IPOs conducted under the standard conversion method in the US. Members received distributions of stock that were subsequently listed and traded in the stock market. Most converting building societies were large, mature institutions. Because the purpose of most of these demutualizations was not to raise capital, nine out of ten conversions did not sell additional shares of stock. Thus, these transactions are commonly referred to as “flotations” in which the original members and subsequent buyers could buy and sell the original shares of stock. After examining the performance of building society stocks over the last fifteen years, Shiwakoti et al. (2004: 3-6) argue that this conversion method did not yield underpricing of shares. By that indicator, the members received full fair market value for their ownership stakes in the mutuals.

Several policymakers and credit union leaders in the US have advocated demutualization for depositories or other reforms that incorporate important elements of demutualization.²⁷ State Senator Dianne Wilkerson (a Democrat from Massachusetts) proposed Massachusetts Senate Bill 26 in 2003 and reintroduced it (numbered as 662) in 2005. Under her bill, conversions of all Massachusetts state-chartered mutual depositories (including MHCs) would use the demutualization model, exchanging members’ joint claims on retained earnings for individual shares of stock *pro rata* to member deposits. The bill would also permit institutions to carry out simultaneous IPOs to raise additional capital (Wilkerson 2005).

Recently, NCUA Chairman JoAnn Johnson asked Congress to consider reforms under which the retained earnings in converting credit unions would be distributed among members, as in the demutualization model (CU Journal 2005j). Former NCUA Chairman Ed Callahan (2004) has advocated that dissenting members in a conversion should have the option to cash out their *pro rata* share of retained earnings. Others argue that conversion votes should include the option to liquidate (and distribute the retained earnings) along with the option of standard conversions (CU Journal 2005g). Most of the advantages and disadvantages listed in section IV C for mutual-to-stock thrift conversions under the standard method also apply to the demutualization model.

²⁷ For instance, the OTS has “note(d) that the FDIC and others have suggested that it may be appropriate for depositors to be able to receive a gift of cash or stock or to transfer and sell their subscription rights so that any “windfall” value can be distributed directly to the depositors” (OTS 1994b: 29).

There are, however, at least six differences. First, under the demutualization model, all members receive tangible compensation in exchange for foregoing their joint claim on the retained earnings of the mutual institution. For this reason, several advocates of the interests of mutual members (including David Schiff, see below) argue that the demutualization model is the “only option that is fair” for mutual-to-stock conversions (Smith 1999b: 29 and Morrison 2004b).

Second, the two methods may not raise the same amount of capital for a converting institution. In the extreme where an institution distributes some retained earnings to members in the form of cash, bears the costs of the conversion (legal, printing, etc.), and does not perform an IPO, the institution might end up with less capital as a result of the conversion. However, unlike the standard method, the demutualization model can tailor the amount of additional capital to be raised to what management believes is needed.

Other related differences are that a properly-priced demutualization IPO might yield only a small or no first-day pop, while by transferring claims on retained earnings from non-buying members, the IPOs for standard conversions routinely yield outsized first-day pops (see section IV B). While the first-day pops of standard conversions may be very attractive to internal and external investors and may raise capital easily, it is not clear that already well capitalized institutions can justify the standard conversion method by the need to raise capital.

Third, when demutualizations are abused, the abuse may be more easily understood by outside observers than the transfers of claims on retained earnings in the standard method. David Schiff argues that the conversion of John Hancock Financial Services, an insurance company, in January 2000 provides an example of how managers may abuse the demutualization model. In that conversion, members received the option to hold on to their *pro rata* allocation of shares of stock or to commit to sell them to the company at the management-determined IPO price on the day of the IPO, receiving a pre-determined cash payout (Schiff 2003: 1-2).

Schiff argues that by setting cash payouts as the default choice and including in the conversion materials a positive four-page summary of the conditions of the company followed by 10 pages describing the risks of stock ownership, management may not have had in mind the best interests of members. Rather, managers would have sought to reduce the initial number of stockholders and buyers (during the initial 21 days in which managers could not buy shares) to maintain the share

price close to the initial deep discount at which the IPO price had been set. (For instance, the price-to-book ratio implied by the IPO price for John Hancock was far lower than those for similar companies). In the end, members with the right to an aggregate 75 percent of retained earnings accepted the cash payout. After the 21 days, managers could buy shares at those discounted prices and benefit from price increases. Within one year, the stock price increased from \$17 to \$34.40. Whereas management had argued that raising capital was a key reason to convert, the company sold \$1.7 billion of new shares, bought \$1.4 billion of shares from members, and thus raised only a net \$0.3 billion in new funds (Schiff 2003: 3 and 6-7).

Thus, both demutualizations and standard conversions may provide members less than their *pro rata* claims on retained earnings. The differences are that disparities tend to be smaller in demutualizations and they are more obvious to outside observers. Had John Hancock engaged in a standard conversion, the 75 percent of members who did not choose to hold on to their shares would not have suffered the disparity between a cash payout of \$17 per share and share prices of \$34.40 after one year. Very few, if any, of these members were likely to buy stock. Under the standard conversion method, these members would have received \$0 instead of \$17 per share. Further, it is likely that in a standard conversion, many of the 25 percent of members who chose to hold on to the stock would not have actively participated in the IPO, thus also receiving value of zero. In retrospect, abandoning the free distribution model in 1974 may have succeeded in obscuring evidence of disparities across members and related scandals, but at the price of actually leading to worse, but less obvious, disparities.

Fourth, since demutualizations may need to calculate the *pro rata* share of retained earnings across members, their conversion process may take longer (in some cases 18-24 months) and involve some additional costs. Thousands of members holding small stakes could also lead to odd-lot shareholders who impose high maintenance expenses on companies and who trade less often, thereby decreasing the liquidity of the stock. The precise formula used to allocate shares could also lead to litigation. However, none of these shortcomings are insurmountable since demutualizations have been implemented for many years in both insurance companies and depositories in the US and other countries (NAMIC 1999: 3, Smith 1999b: 29, Daily 2000a: 6-7, and Shiwakoti 2004).

Fifth, the two methods may not prevent conversions that seek to benefit some class of members or external investors at the expense of average members to the same extent. While opponents of the cash out option in standard conversions argue that this option is only a subterfuge to prevent conversions, opponents of the similar demutualization model argue (1) that the lure of cash or stock distributions would attract professional depositors, (2) that it would put undue pressure on members to convert to receive one-time payments, and (3) that professional depositors would benefit at the expense of long-time members (OTS 1994b: 29, ACB 2003: 5-7, and CU Journal 2005k).

However, it is difficult to know how many conversions there would have been under either the standard method or the demutualization model, if only one option had been available over the last three decades. Figure 7 in the appendix displays the number of mutual thrifts, stock thrifts, and mutual-to-stock conversions from 1975 through 2004 in the US. Table 10 and figure 8 in the appendix display assets in mutual thrifts, stock thrifts, and all thrifts and their shares out of all assets in depository institutions (including credit unions and commercial banks). The decline in numbers of mutual thrifts (from 3,791 to 625) and their share of assets (from 23.7 to 1.4 percent) during this period does not depict the standard conversion method as a bulwark for members who wanted their institutions to remain mutual.²⁸

Further, the argument that average members would drive conversions under the demutualization model does not fit the historical experience of either mutual insurance companies or depositories in the US or in other countries. Rather, conversions, whether under the demutualization model or standard method, most often appear to be proposed by managers and directors to their largely uninformed members, who participate in conversion votes either in low numbers or largely due to active proxy campaigns initiated by management.

If professional depositors actively drove conversions under the demutualization model, the model could easily be amended to reduce incentives for late deposits. For instance, individual institutions could amend their charters so that conversion rights could be linked to the length of deposits (see section V B). Individual institutions could also use a recent date to determine the size of conversion rights (e.g., one year prior to the conversion), but set an earlier date to determine

²⁸ Whereas the corporate income tax exemptions for credit unions complicate direct comparisons, the relative performance in the asset shares of credit unions and mutual thrifts during this period is stark.

eligibility to participate in conversion votes and to receive conversion rights (e.g., accounts of any size for at least ten years or accounts of over a certain size, e.g., \$100, for at least three years prior to the conversion). Either of these mechanisms would impose high costs on professional depositors and reduce their likely returns, the number of professional depositors, their influence on conversion votes, and the overall size of the problem.

Sixth, it is likely that members receiving cash or stock in thrift demutualizations would be taxed upon receiving them. This is unlikely to be a major inconvenience from the point of view of non-buying members. Using the earlier example of the John Hancock conversion, most members would prefer being taxed some on the receipt of \$17 per share (under the demutualization model) to foregoing a tax liability and receiving no payments (under the standard method).

Some critics also make a case against the demutualization model based largely on arguments of legal stability across time and territorial jurisdictions. They argue that because the standard conversion method has been consistently applied in thrifts for several decades and across many states, no major changes should be attempted. These critics argue, in effect, that thrift demutualizations should not be permitted because under the demutualization model “benefits will be transferred to depositors, who do not have the right to receive such a windfall.” Critics also argue that if one state introduced the demutualization model, the change might lead to similar efforts in other states (ACB 2003: 6). These arguments ignore that legislators and regulators may want to update legislation and regulation periodically to reflect changing economic conditions and to remedy policy mistakes. For instance, section IV B presented how the standard conversion method may have been appropriate during the 1980s when many thrifts were deeply undercapitalized. As capitalization levels rise, legislators and regulators may find that they should consider permitting other conversion methods.

Thus, we present a number of potential reforms of conversion policies that could be implemented by the NCUA, even without new legislation.²⁹ Under current legislation and regulations, credit unions

²⁹ Whereas the OTS is unlikely to implement these reforms, the OTS would also have broad authority to apply them to mutual-to-stock thrift conversions without needing to change legislation. Table 11 in the appendix presents these potential reforms in an abridged form.

wishing to convert to the stock form first convert into mutual thrifts. However, once a mutual thrift, subsequent conversions of former credit unions to the stock form are outside the control of the NCUA and fall under OTS (or FDIC) regulations. As section IV B explained, conversions under those regulations are likely to result in large transfers of value from non-buying members to buying members and external investors.

If the NCUA believed that the members of a credit union were likely to approve a conversion into a mutual thrift that was only an intermediate step to the stock form, the NCUA might prefer that the conversion take place in the manner that most benefits members and that most protects their claims on retained earnings. This approach would likely be the one that (1) did not transfer claims on retained earnings from a majority of uninformed, non-buying members to buying members and external investors and (2) economized on expenses by avoiding unnecessary intermediate conversion steps.

The approach most likely to achieve these goals would be a demutualization of a credit union directly into a stock depository.³⁰ Since the OTS is unlikely to permit direct credit union-to-stock thrift conversions under rules other than the standard conversion method (OTS 2001), the NCUA could develop a set of rules to regulate direct credit union-to-commercial bank conversions that use the demutualization model and that, thus, greatly reduce (or eliminate) transfers of value across members and from members to external investors.

As section III A explains, in 1998 Congress passed CUMAA amending the FCU Act by adding section 205 (b)(2). Pursuant to this section, federally-insured credit unions (FICUs) may convert into mutual thrifts without NCUA approval (subject to several conditions). However, CUMAA did not otherwise amend section 205 (b)(1). Thus, the NCUA would seem to still have its authority to approve and regulate

³⁰ Alternatively, if the NCUA believed that the reason for a conversion was not managers seeking transfers of claims on retained earnings to themselves, but managers committed to the mutual form who are frustrated with field of membership and lending power restrictions, the NCUA might (1) endorse a conversion into a mutual thrift or (2) recommend an immediate conversion into a private MHC (i.e., one with full mutual ownership) that owns a commercial bank subsidiary.

conversions of FICUs into other institutions, including uninsured credit unions, insured stock thrifts, and insured commercial banks (Albin 2000).³¹

The NCUA might also want to consider at least the following four safeguards to strengthen the demutualization model and to address some of the alleged weaknesses of the historical free distribution model. First, to limit the incentives for professional depositors to participate in credit union demutualizations, the NCUA might consider (1) weighing savings (and also loans) by length of time in calculating conversion rights or (2) granting conversion rights only to longer-term members (see sections V B and V C).

Second, to ensure that demutualizations do not prevent institutions from raising capital and to enhance the liquidity of the shares, the NCUA might explicitly permit institutions that demutualize to simultaneously hold standard IPOs (i.e., ones in which new stockholders have claims only on the funds they contribute and not on those of non-buying members). Of course, direct conversions from credit unions to commercial banks would require close cooperation between the NCUA and bank regulators.

Third, to reduce how much the value first received by members deviates from their *pro rata* share of retained earnings, credit unions might distribute only shares of stock (not cash) and restrict how quickly formerly-non-tradable member claims would become fully-tradable shares. For instance, rules might allow members to sell, subsequent to the conversion, up to one-fourth of their shares during the first quarter (or year), up to one-half of their shares during the first two quarters (or years), and up to three-fourths of their shares during the first three quarters (or years). This approach would prevent small shareholders from opting for unfavorable cash payouts or from depressing prices in the short term if many small shareholders tried to unload their shares simultaneously.

³¹ The conversion requirement of a majority of votes cast applies only to credit union-to-mutual thrift conversions. The NCUA could, and likely would, implement different voting requirements and regulations for conversions of credit unions into other institutions. For instance, the NCUA could introduce regulations under which once the board of directors of a credit union approved a conversion plan, a petition from a certain percent of members (e.g., 10 or 25 percent of the number voting in the previous election for the board of directors) would lead the NCUA to require the credit union to hold separate votes on (1) whether to convert or not and (2) what conversion method to use (i.e., first into a mutual thrift and perhaps subsequently into a stock thrift under the standard conversion method or directly into a commercial bank using the demutualization model).

Fourth, since brokerage commissions are likely to detract a far larger percent of the value of shares sold by small stockholders, former credit unions that demutualize might commit to purchase shares at market prices from small stockholders directly for an extended period of time (e.g., four years) without charging commissions. The maximum amount of shares that former credit unions would be committed to purchase directly could be capped at, for instance, \$1,000 per member. The number of direct purchases that a former credit union would be committed to make could also be capped, for instance, at four purchases per member.

For each of these safeguards, the NCUA will have to explore whether (1) to require the use of specific safeguards for all credit union demutualizations, (2) to permit individual credit unions to choose which specific safeguards to use, (3) or to give individual credit unions a list of NCUA-approved safeguards from which some options have to be chosen, (4) either through formal charter changes that commit credit unions long before they consider demutualizations or (5) through decisions made shortly before demutualization.

These demutualization proposals would address many of the concerns of conversion critics. In particular, these proposals would prevent transfers of claims on retained earnings from non-buying members to buying members (including managers and directors) and external investors. If the option of conversions under the demutualization model were introduced, when individual credit unions proposed conversions into mutual thrifts, critics of conversions could (1) point out the types of compensation received by members under different conversion methods and ask for separate votes on (2) whether to convert and (3) what conversion method to use. Further, if these proposals were implemented, professional depositors would have far weaker incentives (if any) to participate in conversions. As discussed above, it is also unlikely that typical members would push for conversions under either the standard method or the demutualization model.

To the extent that managers, directors, and members of credit unions seek conversions due to disadvantages in their charter, rather than to engineer transfers of claims on retained earnings from non-buying members, introducing the option of a demutualization model would not restrict charter choice for individual credit unions. Under the demutualization model, individual credit unions that concluded that they could provide more value to their members by foregoing fields of membership and adopting a stock structure could do so.

Finally, this report does not necessarily advocate changing existing legislation or regulation of credit union-to-mutual thrift conversions to make them more or less expedited or costly. At this time, we simply propose adding an alternative method for credit union (and perhaps other thrift) conversions; so that individual members, managers, and directors of depositories may make more informed choices about (1) whether (or not) to convert and, if they choose to convert, (2) which conversion method is most beneficial for them.

SECTION VI: Conclusion

Credit unions, mutual thrifts, stock thrifts, and commercial banks provide a wide variety of services to a wide variety of stakeholders: borrowers, savers, managers, employees, and investors. Deregulation of financial markets has blurred many of the historical distinctions between these financial institutions. As a result, these financial institutions compete vigorously within and across charter types. One distinction that remains, not due to regulation but due to choice, is between mutual and stock corporate structures. Occasionally, individual depository institutions may also change their charters or their corporate structures.

This report provides an overview of the (1) historical origins, (2) corporate structure, (3) compensation of managers and directors, (4) taxation, (5) restrictions on the field of customers, (6) investment and lending powers, (7) capital requirements and ability to raise capital, and (8) regulators and insurers for credit unions, mutual thrifts, stock thrifts, and commercial banks. The report also reviews the history, legislation, and regulation for a variety of conversions across various types of depository institutions.

The interests of various groups of stakeholders in financial institutions are likely to shift as conditions change and sometimes to conflict. As a result, credit union-to-mutual thrift and mutual-to-stock conversions may be controversial and complex. The “standard method” for mutual-to-stock thrift conversions contained in current OTS (and FDIC) regulations may have once been an effective tool to raise capital for seriously undercapitalized mutual institutions in the 1970s and 1980s. Then, in many cases, conversions may have been about the only way for those institutions to survive.

Conditions are different now and the most appropriate policies for different conditions may be different. Today, the credit union and mutual thrift industries have high capital, or net worth, ratios. As they have prospered over the past two decades, these institutions have come under increasing pressure to convert.

Regardless of whether they should, under the reigning standard conversion method, very few members purchase shares of stock during conversions and, thus, forego their *pro rata* share of claims in the large volumes of retained earnings held by well-capitalized institutions. This value is, in effect, transferred to buying members and external investors.

This report also (1) reviews the reasons that proponents and critics of conversions say that conversions occur, (2) presents a conceptual approach that shows whether and when credit union members benefit from conversions, (3) compares the financial characteristics of converting and non-converting credit unions, and (4) reviews some ongoing proposals for reforms of the legislation and regulation of conversion votes.

The report also presents some specific reform initiatives that do not require legislation. We posit that applying variants of the demutualization model to credit union (and thrift) conversions would greatly reduce the transfers of value that are inherent in the current conversion policies and practices of the OTS and the FDIC. By shedding light on the relevant issues and institutions, we hope to stimulate improvements in the understanding and practice of credit union conversions.

Appendix

Table 8: A comparison of credit unions, mutual thrifts, stock thrifts, and commercial banks

| | Federal credit union | Federal mutual thrift | Federal stock thrift | National bank |
|---|---|---|--|--|
| Ownership | Cooperative | Mutual | Stock | Same as thrifts |
| Voting | One member, one vote | Voting may be somewhat proportional to deposits | Voting not related to membership or deposits, but to transferable shares of stock | Same as stock thrifts |
| Dividends (interest) | Proportional to savings (deposits) | Same as credit unions | Depositors receive interest. Non-depositor owners receive dividends | Same as stock thrifts |
| Managerial compensation | Not linked to stock price | Same as credit unions | May be linked to stock price | Same as stock thrifts |
| Directorial compensation | No | Yes. Not linked to stock price. | Yes. May be linked to stock price. | Same as stock thrifts |
| Corporate income taxes | Exempt. Members pay income taxes on their dividends (interest). | Not exempt. Institution pays corporate income tax. Members pay income taxes on interest. | Not exempt. Institution pays corporate income tax. Depositors pay income taxes on interest. Owners pay income tax (at 15 percent rate) on dividends. | Same as stock thrifts |
| Fields of customers | Yes. In general, only members may borrow and make deposits. | No. Anyone (including corporations) may borrow and make deposits. | Same as mutual thrifts | Same as mutual and stock thrifts. Some branching restrictions apply. |
| Limits on securities | Government securities only | Investment-grade securities only | Same as mutual thrifts | Few limits |
| Limits on lending | Cap on business lending | QTL slightly favors residential, credit card, consumer, educational, and small business lending | Same as mutual thrifts | Few limits |
| Methods to raise capital, other than retaining earnings | Low-income credit unions may use secondary capital | Subordinated debt, other debt-equity hybrids (TPS, etc.) | Subordinated debt, other debt-equity hybrids (TPS, etc.), common stock | Same as stock thrifts |
| Lead regulators and insurers | NCUA and NCUSIF | OTS and FDIC (BIF and SAIF) | Same as mutual thrifts | OCC and FDIC (BIF) |

Table 9: Past and pending credit union conversions and merger conversions (1995-January 2006)

| Credit union name | Current name of converted institution (if still independent) | State | Current Form | Assets before conversion (\$ million) | Conversion (or merger) date |
|---|--|-------|--------------|---------------------------------------|-----------------------------|
| Lusitania FCU | Lusitania SB | NJ | PMHC | 52 | 9/1/1995 |
| AWANE FCU | Monadnock CB | NH | MHC | 10 | 5/1/1996 |
| BUCS FCU | BUCS FB | MD | Stock | 58 | 3/1/1998 |
| Synergy FCU | Synergy Bank | NJ | Stock | 176 | 5/1/1998 |
| Affiliated FCU | Affiliated Bank | TX | Stock | 8 | 6/1/1998 |
| Ohio Central FCU | Ohio Central Savings | OH | Stock | 27 | 6/1/1998 |
| IGA FCU | | PA | | 153 | 7/1/1998 |
| Beacon FCU | Beacon Federal | NY | PMHC | 155 | 7/1/1999 |
| Sacred Heart of Charleston FCU | Carolina FSB | SC | Mutual | 17 | 8/1/1999 |
| Kaiser Permanente FCU | Kaiser FB | CA | MHC | 191 | 11/1/1999 |
| Pacific Trust FCU | Pacific Trust Bank | CA | Stock | 224 | 1/1/2000 |
| Atlantic Coast FCU | Atlantic Coast Federal | GA | MHC | 310 | 11/1/2000 |
| Caney Fork Coop. CU | | TN | | 0.3 | 11/1/2000 |
| Rainier Pacific CU | Rainier Pacific Bank | WA | Stock | 383 | 1/1/2001 |
| Roper Employees FCU | | SC | | 7 | 3/1/2001 |
| AAL CU | | WI | | 38 | 6/30/2001 |
| AAL Members CU | | WI | | 173 | 6/30/2001 |
| AGE FCU | Heritage Bank of the South | GA | MHC | 269 | 7/1/2001 |
| Professional Teachers' CU | | TN | | 0.9 | 7/1/2001 |
| Allied Pilots Assoc. FCU | Allied First Bank | IL | Stock | 76 | 9/1/2001 |
| Citizens Community FCU | Citizens Community Fed. | WI | MHC | 102 | 12/10/2001 |
| Community Schools CU | | MI | | 41 | 1/1/2002 |
| Salt City Hospital FCU | | NY | | 8 | 3/1/2003 |
| CU of the Pacific | Sound CB | WA | Mutual | 134 | 5/19/2003 |
| @LANTEC Fin. FCU | Bank @LANTEC | VA | Mutual | 94 | 1/12/2004 |
| Washington's CU | 1 st Sec. Bank of Wash. | WA | Mutual | 290 | 3/31/2004 |
| Share Plus FCU | Share Plus FB | TX | Mutual | 152 | 10/1/2004 |
| Community CU | ViewPoint Bank | TX | Mutual | 1,403 | 1/2/2006 |
| OmniAmerican CU | OmniAmerican Bank | TX | Mutual | 1,160 | 1/2/2006 |
| Pending credit union conversions in 2006 | | | | | |
| Sunshine SCU | | FL | CU | 171 | |

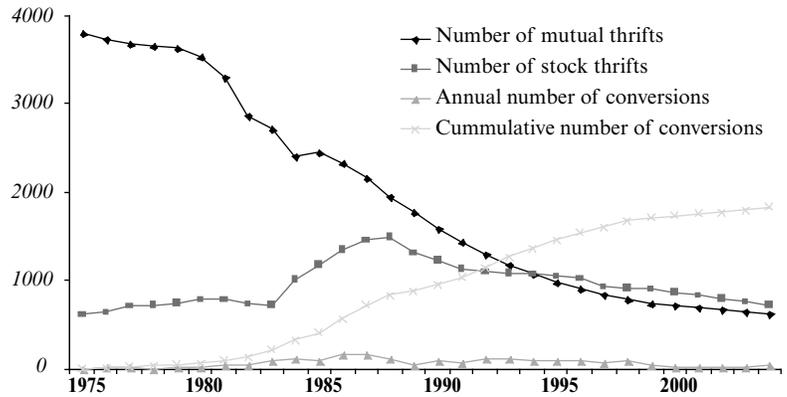
Sources: CU Financial (2005), the NCUA, and the websites of various former credit unions.

Notes: In the column on current form, private mutual holding companies (PMHC, i.e., those that have not sold stock in their stock subsidiary to members and/or investors) are identified separately from mutual holding companies (MHC, i.e., those that have sold stock in their stock subsidiary to members and/or investors).

The table above uses the following abbreviations for the names of institutions: credit union (CU), state credit union (SCU), federal credit union (FCU), community bank (CB), savings bank (SB), federal bank (FB), and federal savings bank (FSB). Assets before conversion are as of the last December 31 before the conversion. For the 2006 conversions, asset size is as of December 31, 2004.

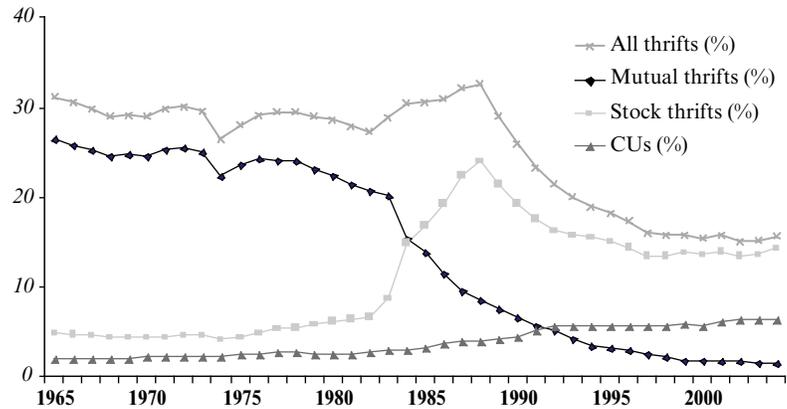
At the time this report was written, the NCUA had approved the conversion for Sunshine SCU, but the conversion had not yet been completed.

Figure 7: Number of mutual and stock thrifts, of annual conversions, and cumulative number of conversions (1975-2004)



Sources: FHLBB (1988), OTS (2005), and the FDIC.

Figure 8: Assets in all thrifts, mutual thrifts, stock thrifts, and credit unions as a percent of assets in all depositories (including commercial banks) (1965-2004)



Sources: FHLBB (1988), OTS (2005), CUNA (2005i), and the FDIC.

Table 10: Number of and assets in mutual and stock thrifts, number of mutual-to-stock thrift conversions, and funds raised by thrift conversions regulated by the FHLBB and the OTS (1975-2004)

| Year | Number of mutual thrifts | Number of stock thrifts | Assets in mutual thrifts (\$ million) | Assets in stock thrifts (\$ million) | Number of mutual to stock conversions | Funds raised in FHLBB and OTS conversions (\$ million) |
|-------|--------------------------|-------------------------|---------------------------------------|--------------------------------------|---------------------------------------|--|
| 1975 | 3,791 | 616 | 369,596 | 67,943 | 1 | 1 |
| 1976 | 3,734 | 639 | 420,523 | 83,490 | 13 | 51 |
| 1977 | 3,676 | 712 | 477,132 | 105,065 | 15 | 30 |
| 1978 | 3,655 | 718 | 533,727 | 121,936 | 5 | 14 |
| 1979 | 3,621 | 741 | 571,989 | 143,231 | 14 | 114 |
| 1980 | 3,534 | 782 | 605,242 | 167,949 | 17 | 141 |
| 1981 | 3,296 | 786 | 626,028 | 188,360 | 37 | 127 |
| 1982 | 2,862 | 740 | 647,933 | 206,896 | 31 | 123 |
| 1983 | 2,713 | 727 | 691,651 | 298,236 | 83 | 2,741 |
| 1984 | 2,408 | 1,010 | 580,904 | 563,342 | 105 | 715 |
| 1985 | 2,442 | 1,184 | 568,444 | 694,210 | 90 | 1,385 |
| 1986 | 2,331 | 1,346 | 519,585 | 867,282 | 154 | 2,482 |
| 1987 | 2,160 | 1,462 | 450,696 | 1,051,414 | 162 | 1,957 |
| 1988 | 1,949 | 1,488 | 421,122 | 1,184,527 | 106 | 767 |
| 1989 | 1,772 | 1,315 | 368,040 | 1,059,471 | 43 | 351 |
| 1990 | 1,585 | 1,230 | 320,048 | 939,130 | 79 | 774 |
| 1991 | 1,434 | 1,127 | 273,788 | 839,214 | 78 | 958 |
| 1992 | 1,296 | 1,094 | 248,631 | 781,583 | 111 | 1,159 |
| 1993 | 1,177 | 1,085 | 211,798 | 789,093 | 119 | 2,285 |
| 1994 | 1,076 | 1,076 | 180,841 | 827,727 | 102 | 2,677 |
| 1995 | 979 | 1,051 | 176,404 | 849,338 | 96 | 2,057 |
| 1996 | 905 | 1,021 | 174,463 | 854,556 | 81 | 1,656 |
| 1997 | 849 | 931 | 163,948 | 862,238 | 57 | 1,359 |
| 1998 | 779 | 911 | 153,669 | 934,751 | 79 | 2,262 |
| 1999 | 740 | 902 | 136,813 | 1,011,711 | 33 | 644 |
| 2000 | 720 | 869 | 141,759 | 1,075,579 | 24 | 369 |
| 2001 | 698 | 836 | 146,092 | 1,170,680 | 20 | 212 |
| 2002 | 674 | 792 | 151,958 | 1,206,988 | 20 | 882 |
| 2003 | 651 | 760 | 154,611 | 1,319,495 | 23 | 1,153 |
| 2004 | 625 | 720 | 152,675 | 1,539,089 | 32 | 1,035 |
| Total | | | | | 1,830 | 30,481 |

Sources: FHLBB (1988), OTS (2005), and the FDIC.

Notes: Mutual thrifts are calculated as the total of mutual FHLBB- and OTS-regulated thrifts for 1975-2004, all FDIC-regulated thrifts for 1975-83, and mutual FDIC-regulated thrifts for 1984-2004. This approach classifies the few FDIC-regulated stock thrifts before 1984 as mutuals. There were fewer than 20 FDIC-regulated stock thrifts at the end of 1983. This approach also excludes the state thrifts that were not regulated or insured by the FHLBB, FSLIC, OTS, and FDIC. Stock thrifts and conversions also include FDIC-regulated MHCs and their conversions.

Table 11: An abridged presentation of a demutualization model for credit union conversions and some possible safeguards

- Credit union members could vote separately on
 1. Whether to convert
 2. Whether to convert into a mutual thrift (and likely later into a stock thrift under OTS/FDIC rules) or to convert directly into a (stock owned) commercial bank using the demutualization model, subject to NCUA approval
- Shares of stock would be distributed to members, under one of the following methods:
 1. *Pro rata* to their deposits and/or loans at a specific date, and only for members whose membership is long enough for their conversion rights to have “vested” (e.g., a minimum deposit of \$100 for at least three years or deposits of any size for at least 10 years)
 2. *Pro rata* to their average deposits and/or loans over an extended period of time (e.g., 5, 10, 20 years)
- Credit union conversions under the demutualization model could simultaneously engage in initial public offerings of additional shares of stock
- Credit union conversions would not distribute cash to their members as part of the initial demutualization
- Credit union members gradually accrue rights to their shares of stock, e.g., they could sell up to 1/4 of their original shares within the first quarter (or year) after the demutualization, up to 1/2 of shares within the first two quarters (or years), and up to 3/4 of shares within the first three quarter (or years).
- The converted institution would offer to purchase small amounts of shares from original, small shareholders at market prices with no fees for an extended period of time (e.g., four years) after conversion. The total purchases per former member would be capped at \$1,000. The number of such buybacks per member could be capped at four.
- The NCUA could determine (1) whether some or all of the elements and safeguards of this version of a demutualization model would be required for all credit union demutualizations, or (2) whether individual credit unions would be given a choice among different types of safeguards either (3) in charter and bylaw changes carried out a predetermined number of years before a demutualization or (4) immediately before such a transaction.

Note: The details and rationales for this version of a demutualization model and its safeguards are presented in sections V B and V C.

Guide To Abbreviations

GUIDE TO ABBREVIATIONS

| | |
|---------|--|
| BIF: | Bank Insurance Fund |
| CRA: | Community Reinvestment Act |
| CUMAA: | Credit Union Membership Access Act (HR 1151) |
| FCU: | Federal Credit Union |
| FDIC: | Federal Deposit Insurance Corporation |
| FHLBB: | Federal Home Loan Bank Board |
| FICU: | Federally-Insured Credit Union |
| FSLIC: | Federal Savings And Loan Insurance Corporation |
| HOLA: | Home Owners' Loan Act |
| IPO: | Initial Public Offering |
| MHC: | Mutual Holding Company |
| NCUA: | National Credit Union Administration |
| NCUSIF: | National Credit Union Share Insurance Fund |
| OCC: | Office Of The Comptroller Of The Currency |
| OTS: | Office Of Thrift Supervision |
| QTL: | Qualified Thrift Lender |
| SAIF: | Savings Association Insurance Fund |

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