Mutual-to-Stock Conversions : An International Perspective

by Michael J Lea

INTRODUCTION

In many developed countries, mutual depository institutions are in decline. This decline has taken the form of a reduction in the number of and the amount of assets in mutual institutions through a combination of conversions, failures and mergers. This article reviews the recent experience of mutual housing finance institutions in Anglo-American countries. The focus of the review is on the mutual-to-stock conversion process which governs the decision to convert and the distribution of post-conversion ownership shares. A fundamental question is who owns a mutual institution. The answer arrived at by courts, legislators and regulators differs markedly across countries. As a result the incentives for and thus the pace of conversion differs across countries. This review is part of a larger on-going study by the International Union on the future of mutuals.

SOME HISTORY

The concept of mutuality in depository institutions has a long history. Many of the early savings institutions in Europe and the U.S. were mutual "self-help" societies. Building societies first appeared in Britain in the second half of the 18th century and the U.S. in the first half of the 19th century. These institutions were created to pool member savings in order to make loans for the purpose of purchasing a house. Early building and loans were terminating building societies (i.e., they drew savings from and made loans to a fixed group of people for the express purpose of home construction, improvement or purchase - when all loans were repaid the accumulated savings were returned and the charter extinguished). Later societies were permanent (i.e., accepting both borrowing and non-borrowing members).

Despite early problems with fraud and mismanagement, the building society/savings and loan concept flourished in both countries.[1] In addition, it spread to other Anglo-American countries (Australia, Canada, New Zealand, South Africa). Mutual organizations were also formed in Continental Europe and Scandinavia. These institutions were primarily mortgage or savings banks. Only in Austria and Germany did the building society form of organization (*Bausparkassen*) take hold. These institutions were organized as either private stockholder owned companies or public companies indirectly owned by state governments.

A major factor in the development of mutual institutions appears to have been the lack of provision of savings instruments and housing finance to moderate to middle income households by commercial banks. This gap reflects several factors. In their early development, many commercial banks may not have had the incentive or infrastructure to deal with retail customers. Also, in a number of countries, commercial banks were actively dissuaded from retail lending by governments eager to channel resources into rebuilding commerce and infrastructure. The risks of housing finance were also a deterrent to commercial bank provision. Managing credit risk is an informational intensive and expensive business requiring the underwriting of individual borrowers and properties. In the early stages of financial market development there are no credit agencies which can provide information on a borrower's ability or willingness to repay loans. Furthermore, there are no appraisal services or reliable house price series to establish the value of collateral. Funding risk has also been a deterrent to housing lending. Commercial banks have traditionally relied on short term deposits for their funding and thus have been reluctant to make long term mortgage loans.

The early building societies addressed this gap through the voluntary provision of long term funds and their mutual character. Members made regular savings deposits in order to receive a mortgage loan. Deposits remained in the institutions until a loan was made available. The society was part of the local community and members were expected to participate in the affairs of the institution. Knowledge of the local market and the borrower was a shared attribute of the members which could not be cheaply duplicated by the banks. Thus the societies had lower information costs in managing credit risks and less funding risk in making long term mortgages than commercial banks.

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An important characteristic of the early mutual financial institution was that its members were in fact shareholders, not depositors. They had no guarantee for the return of their savings nor a fixed rate of interest on such savings. Members would meet periodically and vote on a dividend for savers. In the early societies this dividend was not paid out but rather credited to the member's account. The dividend was a function of the profits of the institution. In this sense savers were owners of the institutions and their investments had equity risk characteristics.

The concept of a deposit was developed in the late 1800s in the UK. Deposits differed from shares in that they allowed irregular deposits and withdrawals and carried a stipulated interest rate (typically lower than dividends paid on shares).[2] Deposits and savings certificates were created to allow savings institutions to compete for funds with commercial banks. Their use coincided with the switch from terminating to permanent societies in which borrowers no longer had to be savers with the society. The growth of deposits at the expense of shares also reflects the introduction of deposit insurance.[3] US federally chartered savings and loans were originally not allowed to take deposits (Home Owners Loan Act of 1933), but this restriction was eased after the War to allow competition with other institutions.

As noted by Vittas, the development of mutual depository institutions peaked in the 1970s. Since that time, their market share has declined significantly. In the U.S., the failure of many thrift institutions was a major factor in their relative decline.[4] However, in that country as well as the others there has been a process of "demutalization" wherein profitable and successful mutual institutions have converted to stock ownership. In many cases this has been followed by a conversion to a bank charter or takeover by a bank or other financial institution. Table 1 provides some insight the decline of mutual institutions in Anglo-American countries.[5]

Only in the U.K. have the total assets of mutual depository institutions increased, although the number of building societies has diminished by 30% in 6 years (including the second largest society, the Abbey National, which converted to private limited company status in 1989). Although building societies continue to dominate the mortgage market, the recently proposed acquisition of the Cheltenham & Gloucester (C&G) building society by the Lloyds bank has led some analysts to speculate about long term survival of mutual depositories in the U.K.

A number of factors may be responsible for the decline in mutuals in developed country financial markets. The first is the change in the characteristics of mutuals themselves. With expansion, separation of borrowers and savers, and introduction of the fixed term savings deposit, the comparative advantage in managing credit and funding risk enjoyed by mutuals has been reduced. Second, development of the financial markets has created new long term savings vehicles for households (e.g., insurance and pension funds). Increased education and wealth have increased the demand for more sophisticated financial products by consumers. As a result, personal savings have been flowing to mutual funds, retirement funds and the equity markets. These alternatives not only reduce the attractiveness of mutual deposits but also provide a pool of long term funds that can be tapped by other types of institutions (i.e., mortgage bond and mortgage-backed security issuers) for long term credit provision. Third, commercial banks have discovered the retail market. Deregulation combined with a loss of corporate loan markets to securitization has led to a refocus on consumer markets long neglected by commercial banks.

With increased competition and lower margins, mutuals have sought increased powers and pursued growth strategies in order to achieve economies of scale and improved risk diversification. In the U.S., deregulation in the early 1980s was motivated by the desire to diversify in order to improve earnings and more effectively compete with commercial banks. The U.K. Building Societies Act of 1986, the South African Building Societies Act of 1986, and the Martin Report in Australia in 1991 had similar motivations. The ability to raise additional capital is a key factor behind these strategies. As a result, many mutual institutions have sought to change status to equity ownership.

MUTUAL-TO-STOCK CONVERSION

As noted by Fiechter in the article in this issue, since 1974 over 1,000 mutual savings associations have converted to the stock form of ownership. Over 80 percent of these conversions have taken place since 1982 with 300 conversions taking place since 1989. The primary rationale for conversion has been to raise equity capital. A significant number of the conversions in the 1980s were supervisory conversions or as

Table 1 : Trends in Mutuality

Country	Year of Deregulation	Number of Mutuals	Pre-conversion Assets (billions)	Post-conversion Status (as of)	Number of Mutuals	Current Assets (billions)
Australia	1991	50	A$ 21.6	6/93	31	A$ 12.1
South Africa	1986	13	R 29	12/92	3	R 1
United Kingdom	1986	151	£ 140	12/92	105	£ 260
United States	1981	3,993	$ 604	9/93	1,240	$ 230

a predicate to merger with a stock institution (Kroszner & Strahan).

In South Africa, 10 out of 13 mutuals converted to equity ownership after passage of the Act and all of these institutions have become part of bank groups or converted to commercial banks. The primary reasons for conversion were the need for additional capital to support business diversification and the desire to more effectively compete or merge with bank groups.[6] Similar rationales have been expressed by mutual building societies in Australia which also had the incentives of operating across state boundaries and obtaining deposit insurance. The conversion of the Abbey National in the U.K. in 1989 was motivated by the desire to provide a complete range of services to customers to prevent customers from "... crossing the street and going to a bank for the services that a building society could not offer them" as well as the increased flexibility of operations and access to a wider range of equity sources.[7]

Given a rationale for conversion, how does an institution proceed? Who actually makes the decision to convert and who owns the converted institution?

Reserves of mutual institutions are a valuable asset in most cases. At least four groups have been identified as possible claimants to this value: depositors, management, the community and the federal government.[8] *Depositors* arguably have the strongest claim to the preexisting net worth of a mutual institution. Depositors of the earliest mutuals were clearly owners, putting their funds at risk and controlling the enterprise. Over time, as the number of depositors increased, control shifted from depositors to managers. The advent of deposit insurance, which makes the government an implicit business partner, sharply reduced the risk to depositors' funds.

A comparison of the ownership rights of mutual depositors with the ownership rights of corporate shareholders further illustrates the limits of ownership claims of depositors. Mutual members do not receive dividends, have no power to sell their interest in the net worth of a mutual and lack the power to control an institution's management the way that corporate shareholders can. Furthermore, voting rights are often distributed on the basis of one-member one-vote in contrast to corporate shareholder interests which are typically in the form of one share - one vote.[9] By placing deposits at a fixed rate in a mutual institution, account holders do not assume any liability or take on the risks normally associated with corporate ownership. The lack of risk can be seen in the structure of rates offered to mutual depositors relative to investors in other, riskier ventures.

Even if depositors were equity owners in a risk-bearing sense, it is questionable whether distributing all of the existing equity to depositors in a conversion is fair. All past depositors have contributed toward the accumulation of capital in a mutual institution while only *current* depositors will benefit from a conversion. An equitable allocation of a mutual institution's net worth would need to be made to all depositors, past and present, based on a combined weighting of the size and longevity of their deposits. However, such an allocation would be impossible, since many past depositors have died or are unreachable. Consequently, giving all of the net worth to current depositors confers a windfall to them. In some cases, borrowers are also classified as members. In the past, borrowers were almost always savers, but in the modern mutual there is no requirement to have been a saver and often no correlation between borrowers and savers.

Management's justification for claims to a mutual institution's net worth is that its skillful running of the institution has fostered the mutual's growth in value. One can argue, however, that management has already been paid for performing those functions. Management may contend that it has accepted lower compensation than it otherwise would have in a stock institution due to the lack of stock options and other share value incentives. Such claims are dubious, given the free market for the services of financial institution managers. Because depositor owners exercise less control over managers than stockholder owners, mutual managers may enjoy greater job security (e.g, protection against takeover) and receive greater in-kind compensation (e.g., benefits, perks) than stock managers.

In the past, mutual institutions were *community* based. Arguably some part of the institution's value derives from its name recognition and good will in the community. Also, to the extent that past depositors lived in the community, the community is a proxy for past depositors. The depositor and borrower base of the vast majority of mutuals today extends far beyond the individual community. Thus the link to past depositors is quite weak. Furthermore, the character of the communities in which many mutuals reside has changed dramatically over the years. In some cases, the institution may have no name recognition and may not even materially service the community in which its head office exists. Therefore, the community would seem to have the weakest claim to the net worth of the institution.

The *government's* claim to ownership lies in its promise to protect insured depositors. In so doing it becomes the residual bearer of risk. One need not look beyond the experience of the U.S. savings and loans in the 1980s to understand the nature and magnitude of this risk. As a risk bearer, the government is arguably an owner. In this sense, a portion of the proceeds from conversion of a mutual institution may appropriately belong to the government. As a residual risk bearer, the government also may create value if insured institutions can attract funds at lower rates (by shifting risk to the government). This value can be enhanced if the insurance is underpriced.

COUNTRY EXPERIENCE

Australia

Conversion decisions are made by eligible members of building societies holding qualified interests. Qualified interests are defined as holding of 100 or more withdrawable or permanent shares in the Society for an unbroken period of at least three months.[10] Qualifying shareholders each receive one vote. In general, approval requires at least 20 percent of members to vote, and at least 75 percent of voting members to approve. Upon conversion, permanent shareholders become equity owners and withdrawable shareholders become depositors (covered by deposit insurance). Interests are exchanged at the rate of one share (par value A$1) per A$1 permanent deposit. They have post conversion voting rights and are subject to payment of deficiency if such exists at any future winding up. There are no pre-conversion set-asides for management or directors (either directly or through retirement plans) although post-conversion preference allotments are allowed. There is a 10 percent limit on individual share ownership for a period of 10 years after conversion.

South Africa

The conversion rules in South Africa (as stipulated in the Building Societies Act of 1986) are quite similar to those in Australia. The definition of qualifying interest excludes shares issued during the 12 months preceding the conversion date but a shorter period can be adopted upon regulatory approval (the limit was 90 days for the United which was the first and largest society to convert). As in Australia, directors and management do not receive pre-conversion allocations. The major difference is that shareholders must actively decide to exchange their shares at an offer price determined by the society. Those not exchanging shares receive cash proceeds based on the average price of shares sold publicly. In the case of United, small shareholders (less than R 1,000) were not offered shares in the new company (their shares were exchanged for cash). Thus, the post-conversion society (or holding company) had the possibility of obtaining equity through conversion to the extent that the price from public sale of shares exceeded the price paid to non-converting shareholders.

United Kingdom

The Abbey National has been the only building society to convert to a bank. According to the Building Societies Act, only those members with 2 or more years of continuous membership could receive priority rights (i.e., share or other compensation) yet all members were eligible to vote. The Act further requires that at least 20 percent of members must vote and, of these, 75 percent must vote in favor of conversion. In the Abbey National conversion, 100 free shares were given to each member (depositor and borrower). The only exclusion was members with accounts less than £100. All members eligible for free shares were also given the right to apply (and pay) for additional shares. Management and employees were given the right to subscribe for additional shares on an equal basis with borrowers and depositors. The share offer was oversubscribed and the Abbey National floatation raised almost £1 billion. The post-conversion institution was initially entirely owned by pre-existing members.

In April 1994, the Lloyd's Bank made a bid for the Cheltenham & Gloucester building society. There are a number of differences between this proposed transaction and that of the Abbey National. First, Lloyd's proposed paying all members of more than 6 months (both depositors and borrowers) cash payments based on the size and type of their accounts (£500 to borrowers and small depositors and rising payments up to £10,000 to larger depositors). Second, the result of the merger would have been the disappearance of C&G as a free standing organization. It would have been a subsidiary of Lloyd's Bank.

In June, 1994, the High Court ruled the Lloyd's bid illegal on the account that it violated the rule limiting payment to members with less than 2 years membership. The rationale given for this rule is to discourage potentially destabilizing speculative funds from flowing in and out of building societies in anticipation of conversions or takeovers. The implication of this ruling is that the number of shareholders eligible for payment is significantly reduced. As a result, approval will be more difficult as at least 50 percent of those eligible to vote and 75 percent of those who actually do vote must affirm the proposed transaction. In August, 1994 a revised cash offer only to those shareholders eligible to vote under the Act was made.

United States

The dynamics and regulatory treatment of conversion are described in the article by Jonathan Fiechter in this issue. The rules governing conversions were liberalised during the 1980s to provide incentives to recapitalise thrifts. Conversions brought in new capital and frequently new management attracted by the potential for high returns based on share performance. A significant change was to allow management and directors to receive significant priority allocations of shares in a conversion. Until April of 1994, insiders could theoretically acquire up to 47 percent of a converting mutual thrift institution. The main vehicles for acquisition are Employee Stock Ownership Plans (ESOPs, which were given first priority of up to 10 percent of an offering) and Management Recognition and Retention Plans (MRPs, allowed 3 to 4 percent of an offering in priority after depositors). Office of Thrift Supervision rules allow insiders as individuals to take up to 25 or 35 percent of the stock offering, depending on the size of the institution. No single individual could purchase more than 5 percent of the offering. Because in most institutions the officers, directors and employees are depositors, their priority to purchase shares exists simultaneously with that of other depositors. All depositors with continuous membership of 90 days or more were eligible to vote. As a matter of practice, the vast majority of votes were ceded to management through the use of "running proxies" or proxy cards signed by depositors at the time they opened their accounts.

The rationale for conversion is now different as almost all converting institutions are well capitalised. In the US, the powers of mutuals are not significantly different from those of stockholder-owned thrifts. The primary motivations are management enrichment or as a precursor to merger with a stock institution. Insiders have been able to acquire a large portion of shares and often realise a post conversion windfall gain reflecting the difference between the pre-existing net worth of the institution and the post-conversion market value including the proceeds raised from new stock issuance.

After new guidelines issued by the OTS in April 1994, MRPs are not allowed to participate in pre-conversion allocations. ESOPs are ranked below eligible account holders. The use of running proxies in conversion voting has been terminated. Preference shares in a community can be offered to eligible account holders who reside in association's "local" community and within 100 miles of an office. Only account holders of one year or more are eligible to vote and receive post-conversion shares.

CONCLUSION

The decline in the economic advantages of mutuality combined with increased competition for funds has led to a significant reduction of mutual depository institutions in Anglo-American countries. One aspect of this decline is the conversion of mutuals to stock owned institutions. The conversion process raises a number of interesting questions, the most important of which is the ownership of the institution and its pre-conversion net worth. In order to protect mutuals and their reserves, legislators and regulators have subjected conversions to a number of restrictions centering on voting and share allocation eligibility.

The differences in treatment of these issues across the small sample of countries covered in this study is striking. Only in the U.S. are management and directors accorded significant priorities in share allocation. Evidently, other countries' view of the value created by management is much lower than that in the U.S. as no other country allows significant preferences for insiders. Other groups have a mixed treatment. Only in the U.K. do borrowers have the right to receive cash or stock. Communities do not receive any proceeds from conversion. Government and the taxpayer do not receive any proceeds from conversion (except through capital gains tax on shares sold after conversion). However, only in the U.S. does the government have a significant claim to such proceeds.

The questions raised by mutual-to-stock conversions promise to be with us in the coming years as the decline in mutuals continues. In subsequent issues we will report on trends in mutuality in other countries. ■

NOTES

[1] For a review of the history of mutual depository institutions see Vittas (1994).

[2] See Bodfish and Theobold (1940) for a history of savings and loan institutions and Boléat (1992) for a brief discussion of the history of building societies.

[3] U.K. depositors have 80% coverage upto £20,000. U.S. depositors have 100% coverage upto $100,000 per account.

[4] For a discussion of the role conversion played in the "thrift crisis" of the 1980s see Kroezner & Strahan (1993) and Cordell, MacDonald and Wohar (1993).

[5] Excluding credit unions.

[6] Prospectus of the United Building Society upon conversion in 1986.

[7] Fry (1989).

[8] For further discussion in the U.S. context, see Barth, Brumbaugh and Laub (1994) and the Shadow Regulatory Committee (1994).

[9] In the U.S., depositors have one vote per $100 on deposit upto a maximum of $10,000.

[10] Details on conversion aretaken from the Explanatory Statement of Members by the Co-operative Building Society of South Australia Ltd., August 27, 1993.

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