Mutual-to-Stock Conversions in the United States

by Jonathan L Fiechter

INTRODUCTION

For the past 20 years - since the former Federal Home Loan Bank Board (FHLBB) implemented its mutual-to-stock conversion regulations in 1974 - mutual-to-stock conversions have been a successful vehicle for bringing new capital into the thrift industry. Only a handful of mutual-to-stock conversions were conducted prior to 1974; however, since then, over 1,000 mutual savings association have converted to the stock form of ownership, in the process raising approximately $16 billion in new capital. Almost 300 thrifts have converted in the last four years, raising nearly $5 billion in capital. During that same time, an additional 15 mutual institutions have formed mutual holding companies, raising $105 million.

As these numbers suggest, a principal benefit of an institution converting from the mutual to the stock form is raising capital, a result that can otherwise be difficult for mutuals to achieve. Mutual associations can increase their equity base only from retained earnings. This can be a lengthy process. Capital-deficient mutuals, in particular, have an incentive to promptly raise capital in order to achieve capital adequacy and thus avoid the wide range of regulatory and supervisory actions that regulators take against inadequately capitalized institutions. While a mutual may issue subordinated debt, the interest payment feature of the debt and the limitations on its use for meeting regulatory capital requirements may make it unattractive or inadequate to meet the institution's capital needs.

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OVERVIEW OF THE MUTUAL-TO-STOCK CONVERSION PROCESS

Types of Conversions

A mutual-to-stock conversion may be structured as a standard conversion or holding company conversion, a merger conversion, or a mutual holding company reorganization.

A standard conversion or holding company conversion simply involves a mutual institution converting to stock form - the conversion stock offered for sale is the stock of the converted institution.

A slight variant that is more common today involves a mutual institution converting to the stock form in connection with the formation of a holding company. In this type of transaction, called a holding company conversions, stock of the holding company is offered for sale and the converting institution becomes wholly owned by the holding company.

A second form of conversion is a merger conversion, involving the acquisition of the mutual institution by a stock institution. In this case the stock of the acquiring institution (or its holding company) is issued in the conversion and the mutual thrift is merged into the acquiring institution.

Finally, a mutual institution may undertake a mutual holding company reorganization. This transaction is a structural hybrid of a standard or a holding company conversion. A mutual institution charters a subsidiary stock institution and transfers substantially all of its assets and liabilities to the stock subsidiary. The original mutual institution then becomes a mutual holding company by adopting a new mutual holding company charter. In effect, the mutual account holders of the thrift become the owners of the mutual holding company. This structure permits the resulting stock subsidiary to issue up to 49.9% of its stock to persons other than its mutual holding company parent. Generally, under OTS regulations, mutual holding company transactions are subject to the same requirements of the conversion regulations applicable to other types of conversions.

The Conversion Transaction

The decision to convert a mutual institution is typically initiated by the institution's board of directors. After a mutual's directors decide to convert, they adopt a plan of conversion and field a conversion application with the appropriate regulator and notify the mutual's account holders.

The conversion application filed with the regulator usually includes the plan of conversion, a copy of the proxy statement (and all proxy soliciting materials) to be sent to account holders seeking their approval of the conversion, and an offering circular registering the conversion stock. In addition, the institution is generally required to provide some form of valuation of the conversion stock.

If the conversion application receives regulatory approval, the plan of conversion is usually submitted to a vote at a special meeting of account holders. In most cases, a majority of the total outstanding votes of account holders is required to approve the plan of conversion. Account holders may vote in person or by proxy. In the event that account holders do not return the proxy materials, attend the special meetings, or otherwise revoke so-called "running" proxies - proxies executed by account holders at the time they opened an account - management may use the running proxies to vote for approval of the conversion. Federal law requires management to inform account holders of the intent to vote running proxies.

In the conversion process, priorities and incentives are typically established with respect to the purchase of conversion stock. Priority purchase rights may be extended to account holders, the mutual's officers and directors, employee stock benefit plans, such as employee stock ownership plans (ESOPs) and management recognition and retention plans (MRPs), and to members of the general public residing in the communities where the association has offices. Purchase priorities are established to permit individual members of one group to purchase up to a designated amount of stock before members of the group next in priority may make any purchases. For example, account holders could be provided first priority to purchase the conversion stock through the receipt of nontransferable subscription rights. In the event of an oversubscription of conversion stock by account holders , shares would be allocated among the subscribers on a *pro rata* basis.

Under Federal law, upon consummation of a conversion, an institution is required to establish and maintain a "liquidation account" - equal to the retained earnings - for the benefit of existing account holders. This account is intended to recognize the intangible ownership interest of mutual account holders in the net worth of an institution prior to conversion. Each mutual account holder has a sub-account in the liquidation account based on his or her *pro rata* portion of the institution's net worth prior to conversion, adjusted annually to reflect account withdrawals.

A conversion does not impact the normal day-to-day operations of an institution. Account holders continue to hold accounts in the converted institutions in the same amount and at the same terms. Borrowers' loans are also unaffected by the conversion. The amount, interest rate, maturity, security and other conditions of outstanding loans are unaffected by the conversion.

HISTORY OF THE FEDERAL CONVERSION REGULATIONS

Prior to 1948, all savings associations operated as mutual associations. When Congress authorized savings associations to convert from the mutual to the stock form in 1948, concerns were immediately raised regarding conversions and the distribution of the net worth of the mutual institution among potential owners of the new stock. To the extent that holders of the new stock in converting institutions realized immediate gains on their investments, the result could be increased volatility in thrift deposits as would-be investor/depositors shifted funds among thrifts in search of soon-to-be converted institutions. In addition, the potential for large gains would place undue pressure on mutual to convert, and would increase the potential for abuse by insiders seeking to reap a disproportionate share of any gains resulting from conversions. Because of these concerns, the FHLBB and Congress imposed various moratoria on conversions through 1974. As a result, between 1948 and 1974, only a small number of conversions were completed.

In an effort to address these concerns, the FHLBB proposed conversion regulations and held public hearings on them in 1973. At the same time, Congress also held hearings on the need for legislation in this area. Following the agency and Congressional hearings, the FHLBB revised its proposed conversion regulations in late 1973, and adopted them in 1974.

It was generally believed that the new regulations adequately addressed the problems arising from conversion "windfalls". As a result, Congress allowed its conversion moratorium to expire on June 30, 1974; these regulations continue in effect today.

KEY SAFEGUARDS CONTAINED IN OTS CONVERSION RULES

The conversion from a mutual form of ownership to stock ownership creates several concerns. In a mutual-to-stock conversion, the mutual's insiders - its directors and managers - are the parties who initiate and set the terms for the sale of the stock. But they are also potential purchasers of the stock. They, like any purchasers, are motivated to buy low in order to maximize the stock's value to them in the after-market. The account holders who have an ownership interest in the mutual institution are also potential stock purchasers. As such, they too will benefit from the stock's appreciation in the after-market.

Thus, when a mutual institution converts to stock form, the transaction is one-sided. There are "typically motivated" buyers for the stock, but in a mutual conversion there are no "typically motivated" sellers, that is, sellers interested in achieving the highest possible price for the stock. The market thus does not exert discipline over the transaction - the usual tension between seller and buyer is lacking.

It is this absence of market discipline that is most troublesome and creates the potential for abuse. OTS regulation is designed to counteract this tendency by imposing limits or controls on insiders' activities in connection with mutual-to-stock conversions. The overarching control is that these conversion transactions cannot be consummated without OTS approval. To receive OTS approval, an institution must meet the following conditions:

- Purchases by officers and directors in the aggregate are limited to between 25% and 35% of the total conversion stock offering, depending on the asset size of the converting institution. Moreover, no person, acting alone or in concert with others, may purchase more than 5% of the conversion stock - and the institution may set a lower purchase limitation. Finally, in no event may a converting institution loan funds to any person for the purpose of purchasing its conversion stock.

- In addition to the aggregate management purchase limits, a converting institution may establish one or more tax-qualified ESOPs that may purchase, in the aggregate, up to 10% of the conversion stock on a first priority basis. An institution may also establish non-tax qualified plans, but these do not have any purchase priority, and stock allocable to management must be aggregated with other conversion stock for purposes of individual and aggregate management purchase limits.

- Specific subscription priorities are established for the purchase of conversion stock. First priority (after any tax-qualified ESOP purchases) goes to savings account holders with the institution at least 90 days prior to the date of adoption of the plan conversion. The second priority goes to all other account holders. A third priority may be established for management and employee stock purchases. Finally, any stock not sold in the subscription offering must be sold to the public.

- The conversion stock must be sold at a price equal to the estimated *pro forma* market value of the converting institution's stock, based on an independent valuation, on or about the date of the conversion. The appraisal is reviewed by the OTS to ensure there is adequate data to support the estimated *pro forma* market value, for conformity with appraisal methodology and documentation standards, and to verify the appraiser's experience an independence.

- A majority of account holders must approve the conversion, and account holders must be furnished with a written proxy statement describing operation of, and their rights and role in the conversion process. Proxy materials used to solicit votes must comply with disclosure requirements of the Federal security laws and specific thrift disclosure requirements established by the OTS and must be reviewed and cleared by OTS staff. In addition, management may only use pre-existing "running" proxies to vote on the conversion if account holders do not vote their special conversion proxies.

- As with the proxy materials, the offering circular used to solicit account holders and others to purchase the conversion stock must comply with the Federal securities laws and specific OTS requirements, must contain audited financial statements, and must be approved prior to issuance.

The OTS conversion regulations, comprehensive in scope and governing all aspects of the conversion process, set forth specific and detailed standards that have been consistently imposed without exception as regulatory requirements in conversion transactions. These key regulatory controls are consistent with our understanding of the purpose and objectives of Congressional intent in allowing the mutual-to-stock conversion moratorium to expire in 1974.

CONVERSION REGULATION ISSUES

The nature of mutual-to-stock conversions and the dynamics of the marketplace make it difficult to write regulations in this area. In administering the conversion program the OTS continuously reviews the need for changes to its rules and remains open to suggestions for further improvements. OTS, based on its experiences with its conversion program, has revised the conversion regulations several times since 1974. We continue to believe that minimum regulatory standards in the conversion area are desirable to curb the potential for abuse inherent in the skewed economic incentives in mutual-to-stock conversions. If such conversion standards are appropriate for OTS-supervised mutuals, they are presumably appropriate for other mutual institutions that convert.

OTS's rules govern only mutual-to-stock conversions of OTS-supervised thrifts. They do not apply to conversions undertaken by state savings banks. OTS supervises approximately 850 Federal- and state-chartered mutual savings associations. Given the popularity of mutual-to-stock conversions, many of these mutual institutions may choose to convert to stock form. If these institutions change to a state savings bank charter before they convert to a stock institution, they will be subject to state conversion rules.

Differences in State and Federal Conversion Laws

A number of states closely follow Federal conversion rules. Some, however, do not. Differences in those states that do not follow the Federal rules primarily involve:

- the rights and priorities of mutual account holders to purchase conversion stock;

- the amount of conversion stock that institution insiders may purchase;

- the amount of permissible stock incentives that may be given to management; and

- the valuation of the converting institution (and converting stock) at the time of the conversion.

In several states, insider purchasers are not subordinated, and in certain instances are placed ahead of account holder subscriptions for the conversion stock. At least one state imposes no limit on the aggregate amount of insider purchases; and although there is a 10% limit imposed on ESOP purchases, there is no express limit on the combination of insider, ESOP and MRP purchases. Some states do not appear to have any regulatory standards governing management compensation arrangements in conversion transactions. Others have standards that authorise purchases in excess of applicable Federal rules.

Under Federal rules, insiders are restricted from purchasing, in the aggregate, more than 25% to 35% of the conversion stock, depending on the institution's asset size. In addition, tax-qualified ESOPs are limited to 10% of conversion stock, MRPs are limited to 3% or 4% (depending on the thrift's capital position) of conversion stock, and combined ESOP and MRP purchases are limited to 10% to 12% of conversion stock (depending on capital). Thus, in no event could aggregate insider, ESOP and MRP purchases exceed 47% of the conversion stock. That amount could only be purchased if account holder subscriptions were limited and did not exceed 53% of the conversion. More typically, in OTS supervised conversions, management ends up with significantly less than 47% of the conversion stock due to high depositor subscriptions in this process.

Another difference in Federal and state conversion regulation is the method for pricing the conversion stock. Under Federal regulations, a converting institution must issue and sell its stock at a total price equal to the estimated *pro forma* market value, based on an independent valuation, of the stock in the converted thrift. Approved and standardized valuation procedures must be used to make this valuation determination, and the appraisal report must include a complete and detailed description of the appraisal methodology employed. The appraisal is reviewed by the OTS to assess the sufficiency of the data to support the appraisal methodology utilized to value the institution for purposes of stock sold.

Although most state laws require that conversion stock must be sold at the estimated *pro forma* market value of the stock in the converted institution, appraisal requirements vary from state to state. As a result, it appears that the manner in which state savings banks are valued at the time of their conversion is inconsistent.

Recent Trends in Charter Conversions to State Savings Banks

State-chartered savings banks traditionally were BIF-insured institutions, located primarily in New England states. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), however, provided the authority for a savings association to become a state savings bank; these changes in charters have been informally referred to as "Sasser" transactions. As a result of this FIRREA authorization, a number of states outside New England have sought to entice savings associations to shift to state savings bank charters.

Increasingly, mutual institutions that are choosing to convert to stock form find it advantageous to do so under state rules. Because Federal supervision of institutions that change to state savings bank charters shifts to the Federal Deposit Insurance Corporation (FDIC), OTS does not have comprehensive information on subsequent conversions by these institutions that have left our jurisdiction. We have observed, however, that over the past several years, the number of OTS-supervised mutual institutions that have changed to state savings bank charters has increased dramatically. For example, 51 North Carolina mutual institutions recently removed themselves from OTS jurisdiction in favor of North Carolina's state savings bank charter. Of these, nearly half subsequently undertook a conversion - 8 converted to stock institutions and an additional 16 were acquired by another institution in merger conversions. During the same time, only two North Carolina mutuals supervised by the OTS undertook similar conversions. Similar patterns exist in Pennsylvania, Wisconsin and New Jersey.

Of course, differences in Federal and state conversion standards are not the only incentives for OTS-supervised thrifts to change charters. Institutions changing charter can shift supervisory expenses. For instance, OTS-supervised thrifts, whether Federal- or state-chartered, pay for their examinations through explicit fees. By contrast, the FDIC's expenses of examining state savings banks are borne by the deposit insurance fund and thus by all insured institutions that are members of the fund. OTS-supervised thrifts are required to hold stock in the FHLBank System and thus, indirectly, must contribute to the Resolution Funding Corporation and affordable housing obligations of the FHLBank System. Thrifts that change to state savings banks, by contrast, may redeem their FHLBank stock and avoid such obligations.

Recent Changes

The OTS adopted a number of changes in mutual-to-stock conversion rules in April, 1994. These changes derive from an internal agency review of its regulations over the past several months. The review was undertaken because of the surge in conversions by healthy savings associations in recent years; public, congressional and agency concern over the potential for windfall profits for management that initiates conversions; a desire to enhance the role of depositors in conversions; and suggestions that some of the capital raised in a conversion out to be redirected into the institution's community for low- and moderate-income housing and like uses.

Table 1 : Changes in key provisions of the OTS regulations

Old Rule	*New Rule*
Appraisals may contain a "brief summary" of data to support conclusions on pro forma value of converting institution.	Full report is required, as OTS has actually been doing; report must contain sufficient detail to support conclusions as to value.
Running proxy can be used by management unless voting member executes a new proxy or revokes the original one.	Running proxies are eliminated for voting on conversions.
Tax-qualified ESOP has first priority to purchase conversion stock.	ESOP is given status behind eligible account holders.
Converting institutions may opt for a 90-day period to establish long-term depositor status.	Eligibility record date set at no less than one year prior to board of director approval of conversion plan.
Converting association may make a local community offering of stock, but may not prioritize purchases by eligible account holders.	Preference in community offering is to eligible account holders who reside in association's "local" community and within 100 miles of a home or branch office.
Officers and directors can buy 25 to 35 percent of conversion stock and ESOP may but up to 10 percent. Management stock benefit and recognition plans (MRPs) can purchase 3 or 4 percent of conversion stock. Combined ESOP and MRP limited to 10 percent to 12 percent. Stock options can be granted up to 10 percent of shares.	Conversion stock may not be used to fund MRPs. Any post-conversion MRP must be approved by shareholders at first annual meeting. Also, stock options must be voted by shareholders and granted at then current market price. Amounts of stock that can be purchased remain the same.
Merger conversion by mutual savings associations permitted.	Merger conversions prohibited except in supervisory cases where the mutual is undercapitalized. A moratorium on non-supervisory merger conversions has been in force since January 31, 1994.
10-day comment period on proposed conversions.	Comment period extended to 20 days, with allowance of additional 20-day extension.
No business plan required to accompany conversion application unless a holding company is involved. Because most conversions involve formation of a holding company, business plans are generally filed.	Business plan required to demonstrate how converting institution will prudently deploy and use the conversion proceeds. Plan is subject to approval by OTS regional director.
Well-capitalized converted association can repurchase its capital stock up to 5 percent during a six-month period. Can buy back up to 30 percent of stock within three years of conversion.	Stock repurchases prohibited for one year following conversion. With OTS permission, can repurchase no more than 5 percent of stock during a 12-month period for two years following conversion.

Adjusting the regulations to the times is nothing new in their lifespan. Since the basic conversion regulations were first pu on the books in 1974, they have beer updated and modified numerous times. The changes effected today actually remove some of the more liberal provisions tha were put in place several years ago in orde to encourage weak thrifts to raise capital o merge with healthier thrifts.

OTS also has tried to address the community's role. By a separate proposed rule OTS is seeking to enhance the potentia benefits to the community served by the converted institution. How well that institution meets the needs and convenience of its community would become an important par of the agency's review of conversion applications. Table 1 shows the changes in key provisions of the OTS regulations.

CONCLUSION

Mutual-to-stock conversions provide ar opportunity for an institution to raise capital They may also tempt an institution's insiders to engage in transactions that transfe an inappropriate amount of the institution's value to the institution's insiders.

The OTS mutual-to-stock conversion regulations reflect standards and safeguards developed over the years to counteract the lack of market discipline in the process and to respond to the potential for abuses in thrift conversions. Some states do no provide depositors with the same level o safeguards.

We believe there is no compelling reason to permit what amounts to "regulator arbitrage" that may disadvantage depositors or their local communities. To the extent that there have been abuses in the conversion process, consistent standards should be applied to correct those abuses The issue is not OTS rules versus state rules but identifying what abuses, if any exist and applying uniform rules even if tha means changing OTS rules.