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Statement of the Shadow Financial Regulatory Committee

on

MUTUAL TO STOCK CONVERSIONS OF THRIFT INSTITUTIONS

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A large number of mutual savings banks and savings and loan associations have recently converted to stock ownership. In some cases, controversy has developed because of the appearance of windfall benefits. As a result, the FDIC has recently proposed new guidelines for this process.

The Shadow Financial Regulatory Committee (SFRC) believes that

- Conversions are desirable
- Windfall gains result from some conversions
- The stakeholders with a claim on these gains include management, depositors and the FDIC
- All rights to purchase the new stock should be transferable
- The FDIC should receive at least 50% of the rights, which it would sell in the market.

Public Policy Benefits of Conversion

There are benefits from conversion, particularly for undercapitalized thrift institutions. The capital raised represents a cushion against failure, which provides additional protection for the FDIC. Conversion resolves some incentive problems that may exist when management is not accountable to shareholders. For example, mutual thrift institutions tend to spend above-average amounts on management salaries and perquisites.

Stakeholders

The conversion of adequately capitalized thrifts inevitably raises questions about the distribution of the existing net worth of the institution. Such controversy intensified with the recent conversion of Green Point Savings Bank (NY), where the proposed terms were dramatically changed by order of the State Superintendent of Banking.

The Committee believes there are three plausible stakeholders in the existing net worth: managers, depositors and the FDIC. The surplus of many institutions has been built up, at least in part, through the efforts and skill of management. It is, therefore, equitable for management to receive some rewards from the conversion. More important, if conversion is to be encouraged, it is necessary that management receive some benefit, since only management can initiate conversion. Also, after converting to stock ownership, management is more exposed to discipline from shareholders. They must be compensated for this reduction in job security.

The depositors' claim is based on the view that they, in some sense, "own" the mutual. This view is not persuasive. Most depositors have received the market rate of interest on their deposits. Moreover, to the extent that the thrift's net worth has been built up over the years, past depositors, and not just those existing at the time of conversion, have some claim. Assigning large benefits to existing depositors will encourage a flow of speculative deposits to mutual institutions in the hope of a conversion windfall. On the other hand, in many states and under Office of Thrift Supervision guidelines, depositors must approve any conversion plan. Unless depositors are offered a benefit from the conversion, they will have no incentive to vote for conversion.

The Committee believes that the taxpayer, through the FDIC, has the strongest claim on the existing surplus of converting mutual institutions. The taxpayer has taken the risk of loss that is usually borne by the stockholder. The public, that had to pay for the losses of failed thrifts, should reap some of the benefits that also usually go to the stockholder.

Distribution of Rights

It is difficult to determine how to allocate ownership of the existing surplus of converting institutions. The Committee believes that management should receive rights to about 20-30% of the stock offering, depending on the size of the transaction. This is comparable to what managements have typically received in LBO transactions. Since LBOs, by their nature, involve a higher degree of risk, mutual thrift managements should get no more out of the conversion type of reorganization.

Depositors should receive 10-20% of the rights. The remainder of the rights to the stock, at least 50%, should be allocated to the FDIC for the reasons discussed above.

This allocation of rights will encourage efficiency-promoting conversions to continue, while discouraging conversions whose only motivation is to enrich insiders.

Existing policies designed to protect the rights of depositors, and to prevent against expropriation of the surplus by management, are inadequate. The SFRC believes that the most efficient way of achieving this goal and other goals of the conversion involves the following steps.

1. Distribute rights to buy shares in proportion to the agreed division of the net worth between management, depositors (in proportion to their deposits) and the FDIC. The exercise price of the right times the number of shares to be issued will equal the amount of risk capital going to the new stock company. The appropriate amount should be

decided in consultations between management and the relevant regulatory agency.

2. Provide strong incentives to assure that the rights are exercised. To this end it is <u>essential that the rights be transferable</u> and saleable in the market. In a well working market each right will command a price which is equal to the difference between the market value of a share and the exercise price. This means that those that do exercise their rights obtain a proportion of the net worth equal to what they were meant to receive.

Those who fail to exercise will lose that opportunity altogether. The value of rights that are unexercised will benefit those who do exercise, assuming that they express their willingness to oversubscribe, as is generally done. Unexercised rights are distributed between those who exercised in proportion to the rights they exercised.

It is obvious that management greatly benefits if a large number of rightholders fail to exercise. To insure this outcome, management, in the past, has made use of the ruse of making the right <u>nontransferable</u>. Such rights are much less likely to be exercised, for many reasons (see Appendix).

Appendix

Transferable rights can be sold for cash. By contrast, a nontransferable one can only be exercised, which means that the owner must begin by laying out cash, which he or she may not have, to exercise these rights. He or she may not be willing to exercise, since this must normally be done before the price of the stock is known, or can be estimated by a financially unsophisticated depositor, frequently unaccustomed to dealing in stocks. The only information the depositor typically has is the prospectus, which, like that in any securities offering, fully describes the risks that face the firm, and points out all the weaknesses that exist. We have seen no disclosures of the fact that the vast majority of such issues result in large price increases in the first day of trading. As a result, less than 10% of depositors typically exercise their right to purchase stock. This failure, as pointed out above, leaves more valuable rights to management and other insiders.