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## Credit Unions, Conversions, and Capital

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James Wilcox

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# FRBSF ECONOMIC LETTER

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## Credit Unions, Conversions, and Capital

While credit unions have been able to convert their charters more easily since the late 1990s, two conversions of very large credit unions—over \$1 billion in assets each—in 2006 have put the issue on the front burner for the industry.

This *Economic Letter* outlines some costs and benefits to their member-owners of credit unions' converting to stock thrifts and describes one way to reform the process in order to spread the benefits of conversion more broadly to credit union members.

### Background

In recent decades, thoroughgoing financial deregulation has erased many of the charter-based distinctions in the activities, assets, and funding and other regulations between credit unions, thrifts (including savings banks and savings and loans), and commercial banks. Nevertheless, some salient differences remain. Credit unions are member-owned, are largely exempt from income taxes, are restricted to serve specified (but increasingly liberalized and overlapping) fields of membership, and have more restrictions than other depositories on their investments and lending.

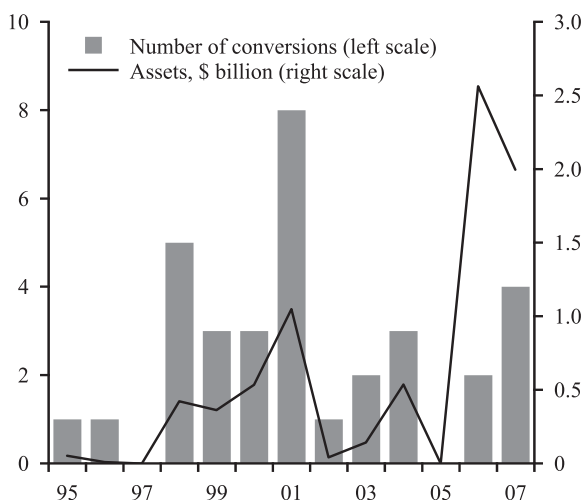
The deposit and loan customers of mutuals are also their member-owners; thrifts may be mutuals or stock-owned, while commercial banks are stock-owned. In contrast to the shareholders of stock-owned firms, who can buy or sell (and use the proceeds of) shares as they wish, individual credit union members do not have rights to withdraw or sell their ownership stakes. Their inability to access already-accumulated capital individually can affect whether a credit union decides to convert to a mutual thrift and later to become stock-owned.

### Conversions and controversies

Recent easing of regulations pertaining to credit union conversions, the large size of some recent converts, the potential for many more conversions, and the incentives for and results of converting make the issue of conversions contentious in the credit union industry.

The 1998 Credit Union Membership Access Act effectively lowered the regulatory hurdles for credit union conversions. Figure 1 shows the numbers and total assets of credit unions that converted to other charters from 1995 through June 2007. Over this

**Figure 1**  
Number of credit union conversions and total assets of converting credit unions, 1995 to June 2007



Source: National Credit Union Administration.

period, 33 credit unions with total assets of \$7.7 billion converted (or merged with non-credit unions), comprising only about 1% of total credit union assets and less than 1% of credit unions.

One concern expressed in the credit union industry is that converting to a mutual thrift charter is often a step en route to abandoning mutuality and becoming stock-owned. Of 20 credit union conversions from 1995 through 2003 (excluding mergers with mutual thrifts and the more recent transactions), 17 have already issued some stock or have merged with another stock-issuing institution. Two credit unions have reorganized as mutual holding companies that have not yet sold stock. From 1975 to 2006, 1,870 thrifts converted from mutual to stock-owned, accounting for more than half of the decline in the number of mutual thrifts and a shrinking of mutuals' share of assets in all depositories from 24% to 1% over that period.

### At what cost benefits?

Because so many credit unions have at least some stock ownership soon after converting, it is perhaps most relevant to consider the costs and benefits of converting from a credit union to a stock thrift. Converting credit unions commonly cite the following advantages of thrift charters: (1) absence of field

of membership restrictions, (2) fewer constraints on investment and lending, and (3) greater flexibility in raising capital. Credit unions that become thrifts also take on some additional obligations, such as paying income taxes and complying with the Community Reinvestment Act and other regulations.

For very many credit unions, the additional obligations of conversion outweigh the advantages. For them, operating as credit unions often results in better interest rates and services for their customers. The larger the (net) benefits of their credit unions, the more likely members will prefer not to convert.

On the other hand, converting offers an opportunity otherwise not currently available to (the members of) credit unions: Converting makes it possible to distribute to the members, for them to use personally in whatever way they see fit, the entire market value of the ongoing institution. Thus, unfettered ability to convert allows members to choose whether to receive the net benefits of belonging and using their credit unions' financial services or to convert and thereby gain access to the accumulated value of the assets that they own.

Credit union members would be expected to weigh the ongoing benefits of potentially better credit union interest rates and services against the amount for which they could sell their stakes in the institution. One way to quantify a credit union's benefits to its members is to compare the "credit union rate of return" (calculated as the ratio of the likely ongoing benefits to the cash proceeds from a sale) to the rate of return on a comparable investment.

It may well be that most credit unions provide rates of return sufficiently high that their members are better off if their credit unions do not convert. For other credit unions, the benefits that they offer may be so low, relative to their capital ratios and other factors that contribute to high market values for their credit unions, that their members might benefit from conversions. Increased capital and profitability partly account for the many hundreds of mutual thrift conversions during the 1990s. Reduced restrictions and the increasing incentives of rising capital ratios likely will spur more credit unions to convert.

### **The standard conversion method**

Current regulations require mutual thrifts that are converting to stock ownership to use the so-called "standard conversion method" (or a similar two-step method). Members do not exchange their group ownership for individually owned shares but, rather, exchange their ownership stakes, pro rata, for *options* to buy shares in the initial public offering (IPO) of shares of stock. This differs from a typical IPO,

after which prior owners have either publicly tradable shares or the cash proceeds from having sold their shares.

Under the standard conversion method, priority rules first grant members options to buy IPO shares, typically in proportion to their deposits as of some prior cutoff date. The value of the IPO shares is based on the appraised value of the thrift, which takes into account the thrift's existing, or "old," capital, its going-concern value, and the "new" capital that the IPO will raise via selling the IPO shares. (Going-concern value encapsulates the value of a firm due to its expected profitability.)

The larger the sum of the old capital plus the going-concern value, the larger the amount by which the total market value of the stock thrift exceeds the amount of the new capital that is raised by selling IPO shares. The prices of conversion IPO shares would be expected to rise immediately to the total market value of the stock thrift. Because the pre-IPO capital and going-concern values are often substantial, we typically observe substantial "pops" in the prices of conversion shares in their first days of trading: The first-day increases in the stock prices of the 17 conversion IPOs of former credit unions had a median value of 19%.

If each member entirely exercised his options to buy IPO shares, then each member would hold a pro rata portion of the shares of stock in the stock-owned thrift, having been a pro rata owner of the mutual and having contributed a pro rata portion of the newly raised capital by purchasing IPO shares. In that case, the members would participate pro rata in first-day pops in the prices of the IPO shares.

Typically, however, only a small percentage of members exercise their options to buy these shares. Members who buy no IPO shares receive nothing. If a member does not entirely exercise his options, then the surrendered value accrues to those who buy the IPO shares, including other, perhaps better-informed, members (including "insiders," such as managers and directors), as well as external investors.

Recognition that the standard conversion method, in practice, often gives better-informed members and outsiders opportunities to benefit financially is widespread and longstanding. However, when converted thrifts had little value other than their just-invested capital, members who did not buy IPO shares did not surrender much. The low capital and going-concern values of converting thrifts during the 1980s meant that the transfers from nonbuying to buying members and to external investors were then likely relatively small. Colantuoni (1998) reports that first-day pops

then averaged less than 6%. As the capital ratios and profitability of converting thrifts rose, so did first-day pops, as expected. Citing growing concerns about the large first-day pops, the Office of Thrift Supervision (1994) revised its appraisal standards. But, so long as converting thrifts have economic value, adjusting appraisal standards cannot eliminate first-day pops—or their resulting transfers from nonbuying members (Wilcox and Williams 1998).

### Capital ideas

Improved capital and profitability of mutual thrifts call for improved conversion methods. For at least a decade, analysts have suggested that the standard conversion method should be used only for conversions of severely undercapitalized thrifts (Unal 1997 and Colantuoni 1998). Its capital-raising feature, however, can hardly be the justification now for the standard conversion method: Average capital ratios are now in double digits and rising; profitability has been strong.

Experience indicates that most members surrender their ownership during conversions and that many better-informed insiders do not. Critics of conversions often point out that management and directors might have conflicts of interest: Better-informed insiders have incentives to advocate conversions and then to exercise their resulting options to buy IPO shares and to institute what may be generous, stock-related compensation packages (Colantuoni 1998 and Chaddad and Cook 2004).

At issue, then, are the possible reforms that could protect members of mutuals, regardless of their level of financial sophistication. One option (Wilcox 2006) builds on demutualization methods that have been used often in conversions by mutual insurance companies in the United States and depositories in other countries (Chaddad and Cook 2004). For example, under current legislation, the National Credit Union Administration could allow individual credit unions to convert directly into commercial banks in a process whereby ownership of the new bank, in the form of shares of stock, could be distributed for free to members, who then could retain their shares or could receive the cash proceeds from selling their shares at market value. In particular, one recommendation is to distribute shares approximately in proportion to members' historical average savings and loan balances,

which likely better approximate (than deposit balances as of a given date) their individual contributions to the economic value of the mutual.

Such a process could reduce the unknowing surrenders of valuable assets by less-savvy members who, under current regulations, do not receive all, and typically do not receive any, of the large amounts of pre-conversion value of their converting credit unions and thrifts.

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