REPORT BY THE

Comptroller General

OF THE UNITED STATES

Converting Savings And Loan Associations From Mutual To Stock Ownership-A National Policy Needed

After studying the conversion of federally chartered savings and loan associations from mutual to stock ownership, GAO found that the process requires the establishment of a national policy.

The Federal Home Loan Bank Board could modify some conversion regulations to be more equitable to management, depositors, and the community. The Board could also require more appraisal documentation and better review stock appraisals to ensure reasonableness of association valuations.

The Congress should establish a national policy on the conversion issue and clarify the legal status of associations which converted after June 30, 1976, and retained their Federal charters. To enable the Congress to resolve the conversion issues now, the Board should provide the Congress with a new definition of association net worth requirements.

UNITED STATES GENERAL ACCOUNTING OFFICE

GGD-79-78

OCTOBER 1, 1979

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-114827

The Honorable William Proxmire
Chairman, Committee on Banking, SEN 00100
Housing and Urban Affairs
United States Senate

Dear Mr. Chairman:

At your request we have reviewed conversions of savings and loan associations from mutual to stock ownership. The review included effects of actual conversions, effectiveness of conversion regulations, evaluation of appraisal methodology and process, and analysis of conversion alternatives. Emphasis was placed on reviewing possible advantages and disadvantages of conversions.

As arranged with your office, we plan no distribution of this report until 15 days from the date of the report. At that time we will send copies to interested parties and make copies available to others as requested.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS UNITED STATES SENATE

CONVERTING SAVINGS AND LOAN ASSOCIATIONS FROM MUTUAL TO STOCK OWNERSHIP--A NATIONAL POLICY NEEDED

DIGEST

The conversion of federally chartered savings and loan associations from mutual to stock ownership requires establishing a national policy. According to the Federal Home Loan Bank Board, the agency which regulates conversions, savings and loan associations change ownership from depositors (mutual) to the public (stock) to improve their equity position, thereby improving their capacity to service housing market needs. Critics argue, however, that conversions can create windfall profits or advantages for management insiders. (See pp. 3 to 6.)

Another issue requiring resolution concerns the right of savings and loan associations to retain their Federal charters after conversion. Although the Board has ruled that this can be done, a 1977 GAO legal opinion disagreed with that decision. As a result, the right of 15 converted Federal associations to do business is in doubt, and the Federal stock charter matter is now under litigation. (See pp. 7 and 8.)

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GAO found that the Federal Home Loan Bank Board has made great strides in protecting the integrity of conversions; that is, in ensuring that conversions will be equitable to both management and depositors. The Board could make further strides by revising some of its regulations and better reviewing stock appraisals. In addition, it could encourage alternatives to improve equity positions, which could reduce the immediate need for some conversions.

In 1974, the Congress enacted Public Law 93-495 to study problems associated with conversion. A provision allowed up to 49 savings and loan associations to convert to stock ownership. Since the provision expired, the Board has continued to accept conversion applications which, if approved, would go beyond the 49 previously allowed by the law.

CONVERSION REGULATIONS, WHILE EQUITABLE, CAN BE IMPROVED

To promote equitable opportunities when savings and loan associations convert to stock ownership, the Board modified and issued new regulations regarding conversions. While its efforts have been commendable, the Board needs to further revise certain regulations.

Further revision is necessary concerning using certificates of deposit to pay for stock without incurring early withdrawal penalties--a regulation which GAO believes is not equitable to all depositors. The regulation allows supplemental account holders to purchase 5 percent of the shares outstanding while allowing people in the community to purchase only 2 percent. This may restrict the wide participation in stock ownership advocated by the Board. (See pp. 10 to 15.)

GAO was also concerned about individual savings and loan associations' methods of managing liquidation accounts, which are established to protect a mutual depositor's ownership rights after the association converts to stock ownership. The Board has issued new procedures which, if properly implemented, should ensure that all account holders retain their rights as long as their money remains in the association. (See pp. 13 and 14.)

IMPROVEMENT IN APPRAISAL REVIEW IS ACHIEVABLE

Appraisals, which are an important part of the conversion process, often utilize the price/earnings method for valuating savings and loan associations. Although this method appears appropriate for most associations, the Board often does not review or question inconsistencies in appraisers' applications of this method.

A review of 16 appraisals showed many inconsistencies in the comparables selected by the appraisers. GAO also noticed various applications of premium and discounts to the price/earnings ratio derived from the comparables. (See pp. 21 to 22.)

OTHER WAYS OF INCREASING EQUITY CAPITAL

Although the Board uses conversions as a way to improve an association's equity position, it can also make adjustments to the net worth requirements to accomplish the same purpose.

Currently, the Board regulations require net worth to be the larger of (1) the Federal Insurance Reserve plus a percentage of scheduled items or (2) the asset composition and net worth index. It must be computed using end-of-the-year account balances.

Two adjustments to these requirements now under study by the Board warrant special consideration. These are the sole use of an asset composition base net worth requirement and the net worth computation based on beginning-of-the-year account balances. If implemented, these alternatives could reduce the need to rely on outside capital, and thus the need for some associations to convert. (See pp. 24 to 30.)

DO DEPOSITORS UNDERSTAND CONVERSION?

Since conversions affect every depositor of a savings and loan association, the Board has required that depositors vote on conversion before their associations can change to stock ownership. On the basis of a limited sample of depositors' attitudes toward conversion, GAO found that about 50 percent did not understand the conversion issue or simply were not interested. In addition, depositor's views on conversion had not changed since their associations' change to stock ownership. (See pp. 31 and 32.)

CONCLUSIONS

The conversion of federally chartered savings and loan associations from mutual to stock ownership requires establishing a national policy. The fundamental question is whether conversions should be allowed which would restructure all or part of the savings and loan industry.

The right of 15 federally chartered savings and loan associations to do business is in doubt, since the moratorium allowing savings and loan associations to convert to stock ownership and retain their Federal charters has expired.

Finally, after studying the conversion process, GAO believes that:

--The Board can modify some regulations to be more equitable to management, depositors, and the community.

--The Board can require more appraisal documentation and can better review stock appraisals to ensure reasonableness of association valuations.

--Alternatives to conversion are available for improving an association's equity position.

--Depositors have little knowledge of or interest in conversion.

RECOMMENDATIONS

The Congress should establish a national policy on the conversion issue and clarify the legal status of associations which have converted after June 30, 1976, and retained their Federal charters.

The Chairman, Federal Home Loan Bank Board, should revise the conversion regulations as follows:

--Delete waiving penalties on early withdrawals of certificates of deposit.

--Reduce the supplemental eligible account holders' maximum allowable stock purchases from 5 percent to 2 percent of the subscription offering.

With regard to stock appraisals, the Chairman, Federal Home Loan Bank Board should:

--Require appraisers to substantiate and/or document their reasons for selecting savings and loan association comparables, applying discounts or premiums to an association's estimated price/earnings ratio, and any other subjective judgment.

--Review the adequacy of these judgments before final acceptance of an association valuation.

In addition, to assist the Congress in establishing a national policy on conversions, the Chairman, Federal Home Loan Bank Board, should provide the Congress with its new definition of association net worth requirements.

AGENCY COMMENTS

The Board stated that a congressional· national policy giving savings and loan associations the right to convert to stock ownership does exist. However, to alleviate any possible challenge to the validity of Federal charters for stock savings and loan associations, the Board agreed that the Congress should clarify the Federal stock chartering authority.

In addition, the Board stated that supplemental account holders' maximum allowable stock purchases will remain at 5 percent. However, if GAO's contention on the shifting of funds to unfairly increase purchasing rights is substantiated, then the regulation would be amended. Board officials concurred with GAO's recommendation that all appraisals contain indepth substantiation of all judgmental questions.

GAO reviewed the Board's position on the possible existence of a congressional national policy on conversions. However, the congressional position is unclear. This stems primarily from inaction by the Congress since the moratorium on conversions expired in 1976.

The supplemental account holder has the advantage of purchasing stock before the community and should not have the additional advantage of purchasing a larger percentage of stock if the objective of wide participation is to be achieved. Therefore, GAO believes that a supplemental account holder's maximum allowable stock purchase should be reduced to 2 percent.

The Board did not comment on GAO's recommendations concerning waiving penalties on early withdrawals of certificates of deposit nor providing the Congress with a new definition of an association's net worth requirements.

C o n t e n t s

ABBREVIATIONS

CD	Certificate of deposit
GAO	General Accounting Office
FIR	Federal Insurance Reserve
P/E	Price/earnings

CHAPTER 1

INTRODUCTION

This is our second report on the issue surrounding the conversions of savings and loan associations from mutual to stock ownership. Our review was initiated at the request of the Chairman, Senate Committee on Banking, Housing and Urban Affairs. In our first report (FOD-77-10, May 26, 1977), we concluded that additional time was needed to monitor the conversion process, refine regulations, and assess further the impact of conversions on the savings and loan industry.

During this review, the Chairman asked that we examine several aspects of the conversion process--Federal Home Loan Bank Board regulations, stock appraisals, effects of ownership transfer, and conversion alternatives. In addition, he asked that we sample the public's attitude toward these conversions.

The Board is responsible for regulating the savings and loan industry. Public Law 93-495, approved October 28, 1974, authorized the Board to allow savings and loan associations consisting of 1 percent of all insured institutions as of October 28, 1974, plus all applications in process, received by the Board prior to May 22, 1973, to convert to stock ownership. This amounted to 49 associations. The limit was set so that the Congress could assess, on an experimental basis, whether conversions were consistent with the public interest.

As of July 31, 1979, the Board had accepted 135 conversion applications; 87 were either incomplete or awaiting Board review, and 48 were approved. Of the approved applications, 36 savings and loan associations have completed conversion and 12 are in process.

The savings and loan associations which have converted raised about $101 million through the sale of their capital stock. Their conversion expenses, which include appraisal, legal and accounting fees, postage and printing costs, and other miscellaneous costs, totaled about $12 million.

THE CONVERSION PROCESS

The conversion process begins with the development of the conversion plan. Board regulations require that the plan be approved by two-thirds of the association's board of directors. After informing its members, the association files a conversion application, including the plan, with the Board. If the Board approves the conversion application, notice of approval is published in the Federal Register. The association then issues proxy statements and any petition to the court for review must be filed within 30 days.

A special meeting is called to obtain the approval of association members to convert. If approved, a preliminary stock offering, approved by the Board, is offered to eligible subscribers. If not fully subscribed, all remaining stock must be sold to the public. The process is completed when the association issues the stock and the Board or State authorities issue a stock charter.

CHAPTER 2

ISSUES FACING THE CONGRESS

The Congress faces two fundamental policy questions in the issue of savings and loan conversions.

The first question is whether savings and loan associations should be allowed to convert to stock ownership. The Board has advocated conversions as a means of enabling savings and loans to acquire needed capital to continue expansion. On the other hand, the Board has allowed a number of associations which did not have capital problems to convert. Should the "need" criterion be one basis or the only basis for conversion?

The second question is whether an association's Federal charter should be retained when it converts to a stock association. At present, because the original provision clarifying this issue has expired, there is a void. Lawsuits and differing legal opinions exist, and the charters for some associations to conduct business are in doubt.

SHOULD CONVERSIONS CONTINUE?

For years, the Board did not allow mutual savings and loan associations to convert to stock ownership, because when associations had been permitted to convert, many abuses occurred. However, in 1971, because savings and loans were experiencing little or no growth and had problems meeting net worth requirements, the Board saw stock ownership as a means to overcome these problems. Therefore, it requested the Congress to allow conversions and approval was given on a limited trial basis. The Congress took this position to study the problems associated with conversions and the techniques available to deal with these problems. However, the provision permitting conversions only on a trial basis expired June 30, 1976.

Conversion advantages and disadvantages

The advantages most often cited by the Board and associations for converting are

--attracting new capital, which strengthens the net worth position;

--increasing mortgage lending activity;

--providing greater resources for branching and expansion of services; and

--attracting and retaining highly qualified personnel.

The need for additional capital to strengthen net worth is a valid reason for allowing an association to convert to stock ownership. However, this is not the only or necessarily the primary reason for some of the conversions. In 16 associations we reviewed, a primary reason given for converting to stock ownership was the need for more capital, which in turn would allow more growth. Board projections show, however, that at the time they converted five of these associations would have been able to meet or exceed their net worth requirements for 5 to 21 years.

With regard to this discrepancy, Board officials stated that their policy is not to discriminate against any association wanting to convert. In our opinion, this policy shifts the basis for converting from one of need for more capital to one of authorizing any conversion that meets the Board's regulations. We do recognize, however, that some of the associations which have converted had serious net worth problems and have benefited, at least initially, from conversion. In chapter 5, we discuss another possible way for associations to improve their net worth problems.

Conversion opponents argue there are monetary windfalls and abuses that may benefit only a few. They contend that the monetary windfall is the transfer of the ownership equity of a mutual association, owned by all its depositors, to a stock association, owned only by its stockholders without payment to the mutual depositors for this equity.

Board regulations require, however, that if a mutual association decides to convert to stock ownership, it must establish a liquidation account, which provides its existing depositors priority rights to the association's equity existing <u>at the time of conversion</u>. The depositors' equity rights are thus protected since the liquidation account is reduced only when a depositor removes funds from the association. This method of relinquishing equity rights based upon removal of funds is consistent with mutual association operations.

However, conversions can lead to problems that might become more widespread if the entire industry is allowed to convert. In our first review, we identified the following problems:

--Members of management and their associates significantly increased their holdings through stock transfers soon after conversion, possibly through insider information or prearranged deals.

--Management and its associates at some associations increased their savings account balances before the conversion eligibility record date, resulting in additional subscription rights to purchase stock.

In our current review, we identified these additional problems:

--Takeover attempts by individuals and holding companies. In one instance, a takeover attempt was made before conversion was even completed.

--Stock prices in a few instances have almost doubled soon after the stock was sold. Whether this was due to market conditions or a poor appraisal is difficult to determine.

We emphasize that these problems generally concern few associations. The Board has revised its regulations to correct some conversion problems. (See ch. 3.)

Lack of participation

One additional fact about conversions is that only 4 percent of the associations' account holders purchased association stock. Why does this happen? Associations are providing enough information, but one-half of the people we surveyed either did not understand or were apathetic toward conversion. Associations wanting to convert often must solicit votes because few people will actually voluntarily participate. Their attitude seems to be to let management run the business.

Status of early conversions

In our first report, we looked at eight associations that had converted before December 31, 1976. Their status 2 years later shows that conversions have been both successful and financially rewarding. However, conversion may not be a good long term solution to improving an association's net worth. It is the net worth position that, under

Board Federal Insurance Reserve requirements, affects an association's growth. (See ch. 5.)

As an indicator of success, the asset growth of the eight associations increased from a 2-year preconversion average of 20 percent to a 2-year postconversion average of 34 percent. Likewise, average mortgage growth increased from 19 to 37 percent, average savings from 20 to 32 percent, and average net worth from 19 to 71 percent. This growth was achieved largely because the eight associations, at the time of conversion, received over $22 million that provided instant equity, which then permitted them to proceed with their expansion programs.

Conversions have also been financially rewarding to stock owners. Two years after conversion, stock prices for six of the eight associations increased an average of 81 percent from the price per share at the issue date. Updated stock price information was not available for the other two associations.

Five of the associations have declared and paid cash dividends. One of these five, plus another, have declared and paid stock dividends--one, a 10-percent stock dividend; the other, a 25-percent stock dividend. Stock splits have also occurred--one association declared a 2-for-1 split, while another declared a 3-for-1 split.

One test that may indicate any lasting association benefits from conversion is the long term effect on an association's net-worth-to-savings ratio. This ratio indicates the amount of reserves for supporting savings. At the time of conversion, seven associations had not experienced any increase in net-worth-to-savings ratios for at least 2 years. The other association's net-worth-to-savings ratio had increased. Upon conversion, seven of the associations' net-worth-to-savings ratios increased by at least 17 percent, while the other association's ratio did not change.

As of 1 year following conversion, none of these associations' net-worth-to-savings ratios had net increases. Instead, five associations' net-worth-to-savings ratios decreased, and the others remained unchanged. If this pattern continues, these eight associations may find themselves in the same financial position they were in before conversion.

THE CONTROVERSY SURROUNDING THE RETENTION OF FEDERAL STOCK CHARTERS

The expiration of the statutory moratorium has left in doubt whether a Federal mutual association could convert to a Federal stock association and still retain its Federal charter to operate a business.

The Congress enacted legislation on August 16, 1973, which imposed a statutory moratorium on converting to the stock form of ownership. The moratorium was effective until June 30, 1974. Public Law 93-495, approved October 28, 1974, extended the moratorium until June 30, 1976. However, the law also authorized additional test conversions and allowed Federal associations to convert to stock ownership without surrendering their Federal charters. On June 30, 1976, the moratorium expired without further congressional action. This has sparked numerous controversies between the Board and conversion opponents.

On March 4, 1977, the Board denied a petition from the Public Interest Research Group for a temporary cease and desist order. The petition sought cancellation of a special meeting called to permit the members of a Chicago Federal mutual institution to consider a plan of conversion to stock ownership. The petitioners' principal objection was that the Board lacked statutory authority to permit the association to retain its Federal charter upon conversion.

On May 10, 1978, a Federal savings and loan association in Washington, D.C., filed suit against the Board in the U.S. District Court for the District of Columbia. The association sought to compel the Board to process its application for conversion to stock ownership. It argued that the Board was delaying the conversion application because of the controversy surrounding the retention of the Federal charter. In October 1978, the suit was dismissed without prejudice and with the understanding the Board would take some action on the association's application. In response to the court order, the Board has requested the association to update its conversion application.

At the request of the Chairman, Senate Committee on Banking, Housing and Urban Affairs, we looked into the differing legal opinions between the Board and the Committee. On the one hand, the Board claimed it had the authority to convert Federal savings and loan associations and allow them to retain their Federal charters. On the other hand, the Senate Office of the Legislative Counsel to the Committee stated the Board did not have that authority.

On July 8, 1977 (Comptroller General Decision B-114827), we informed the Chairman that, in the absence of further congressional action, a Federal mutual institution cannot retain its Federal charter if it converts to stock after June 30, 1976.

Then, on August 28, 1978, the Council of Mutual Savings Institutions, a nonprofit trade organization located in New York City, filed suit against the Board. The suit seeks to determine whether the Board has the authority to permit Federal mutual savings and loan associations to convert to Federal stock savings and loan associations and retain their Federal charters.

The Council is also seeking a judicial interpretation of the fairness of conversions in light of their contention that the Board's conversion regulations result in windfall profits and inequities. As of July 1, 1979, the suit was still pending.

Effects of controversy

Since July 1, 1976, the Board has authorized 42 savings and loan associations to convert to stock ownership. All but 12 had converted as of July 31, 1979. Seven of these associations dropped their Federal charters rather than become involved in legal controversies over their right to do business. However, 15 associations converted and retained their Federal charters while 8 others with Federal charters have been authorized to convert. The remaining 12 are State chartered associations and not involved in the controversy.

CONCLUSIONS

The conversion of federally chartered savings and loan associations from mutual to stock ownership requires establishing a national policy. The fundamental question is whether conversions should be allowed which would restructure all or part of the savings and loan industry.

Since the moratorium allowing savings and loan associations to convert to stock ownership and retain their Federal charters expired as of June 30, 1976, 15 converted associations' legal charters to conduct business are questionable. In addition, other associations are leaving the Federal system and entering into State systems.

RECOMMENDATIONS

We recommend that the Congress establish a national policy on the conversion issue and clarify the legal status of associations which have converted after June 30, 1976, and retained their Federal charters.

AGENCY COMMENTS

The Board stated that through the years the Congress has established a national policy that " * * * savings and loan associations should have the right to convert and that the Bank Board should be charged with assuring the equitability of such conversions."

The Board also referred to its previous position that Federal savings and loan associations could convert to stock ownership and retain their Federal charters. They added, however, that it is unfair to leave the validity of converted associations' Federal charters subject to any possible challenge and therefore the Congress should clarify the Federal stock chartering authority.

We have reviewed the Board's contention that a congressional national policy on conversions exists and continue to believe that the congressional position is unclear. The moratorium on conversions established by the Congress was to take a close look at the value and advisability of conversions. The moratorium on conversions has expired and the Congress has not stated any position on conversions. Therefore, we believe the Congress should establish a national policy on conversions.

CHAPTER 3

CONVERSION REGULATIONS HAVE IMPROVED

BUT ADDITIONAL CHANGES ARE NEEDED

On March 21, 1979, the Board revised and approved new regulations for implementing and controlling conversions. Important regulation changes include (1) limiting the subscription by any person or group of persons acting in concert to 5 percent of the total shares offered, (2) limiting the total shares purchased by officers and directors in the subscription offering to 25 percent of the total offering, and (3) requiring an association to go to the community to sell any shares left over from the subscription offering. While the Board should be commended for these changes, other revisions are necessary to ensure wider participation and fairness to all account holders.

STATUS OF PRIOR RECOMMENDATIONS

Our May 1977 report contained information on the conversion program prior to January 1, 1977. This information, together with our recommendations, was presented to the Board in February 1977. On March 21, 1979, the Board approved new conversion regulations incorporating our recommendations.

We reported previously that six associations were acting as their own stock transfer agents. As stock transfer agents, associations have acted as marketmakers. This has created an insider advantage by giving management first-hand knowledge of all offers to purchase and sell stock. During our current review, we found that another association had acted as its own transfer agent and over 95 percent of secondary stock sales were purchased by management at gradually inflated prices over several months.

The Board's new regulations should help alleviate this problem. They require (1) an association to use its best efforts to ensure that a marketmaker establish and maintain a market for the association's stock and (2) written Federal Savings and Loan Insurance Corporation approval, for the first 3 years after conversion, for any purchase of up to 1 percent of the association's stock by the converted association's officers, directors, or associates, unless the purchase is made through a broker or dealer registered with the Securities and Exchange Commission.

Our previous report also stated that changes should be made to the regulations which require management and associates to report their savings account balances to the Board if they exceeded $40,000 and had been increased by 25 percent during the 6-month period preceding the eligibility record date. We believe that managers with savings accounts under $40,000 could have increased their accounts substantially before the eligibility record date, thus obtaining a substantial portion of the association's stock through inside information. The Board's new regulations adequately address this problem by reducing the $40,000 savings account balance ceiling to $5,000 and increasing the 6-month period to 2 years.

RECENT CONVERSIONS AND SOME NEW PROBLEMS

In our current review, we found some additional problems in implementing and handling conversions. These problems concern (1) limiting stock purchases by eligible account holders to 1 percent, (2) using certificates of deposit to pay for stock without incurring penalties for early withdrawal of certificates, and (3) permitting inequities in the manner savings and loan associations operate their liquidation accounts. After our discussion of these matters the Board modified its regulations and procedures to correct most of the problems. However, the Board needs to further revise its regulations to prevent depositors from using certificates of deposit to pay for stock without incurring penalties for early withdrawal of certificates.

Restricting stock purchases to 1 percent

On an optional basis, one of the Board's 1974 regulations permitted associations to limit each eligible account holder to 1 percent of the total shares offered. This regulation could enable management to purchase more stock than it would otherwise be entitled to. For example, in two recent conversions, associations included a 1-percent restriction in their conversion plans. These plans also included requirements that all unsubscribed stock shares remaining after the subscription offering be purchased by management syndicates. As a result, some account holders were denied the opportunity to purchase as much stock as their account balances dictated, while management purchased the remaining shares.

The Board revised its regulations to prevent management from receiving special treatment by requiring that any limitation on stock purchases be applied to all who participate in the subscription offering. Therefore, if account holders are made subject to a 1-percent subscription limit, management will be also.

Using certificates of deposit to pay for stock

Penalties for early withdrawal are waived for depositors using certificates of deposit to purchase stock in the subscription offering.

A 1973 Board regulation provided that anyone withdrawing all or part of a certificate of deposit (CD) before maturity be subject to a penalty and interest reduction. Specifically, the account holder (1) receives earnings from the date of issuance of the account at a passbook rate on the amount withdrawn, (2) pays a penalty in an amount not less than the lesser of (a) the earnings at the passbook rate for 90 days on the amount withdrawn or (b) all earnings at a passbook rate from the issuance or renewal date of the certificate account on the amount withdrawn, and (3) ceases to earn interest if the CD balance goes below the minimum balance requirement.

However, in 1974, to promote stock purchases, the Board adopted a regulation that waived both the penalty and the interest reduction when CDs are used in payment of stock purchased during the subscription period. In addition, the regulation required that any portion of a certificate left after the stock is purchased continues to earn interest at the same rate, even if the balance is below the minimum balance requirement of $1,000. In our view, this regulation gives preferential treatment to one group of certificate holders.

Recent conversions showed that this regulation is now gaining attention. For example, in one association, over 32 percent of the stock was paid through CDs. In some instances, CDs were cashed 2 years before their maturity. In another association, CDs were opened before the eligibility record date. For example, a former director opened two 4-year CDs 5 months before the eligibility record date. Stock was purchased with the CDs and the CDs closed more than 2 years before their maturity dates without incurring a penalty for early withdrawal.

The Board revised the regulation so that after the purchase of stock, if a CD balance went below the required minimum balance, the remaining money would earn interest at only the passbook rate. This change represents a compromise which does not resolve the preferential treatment issue. The new regulation continues to waive penalties for the early withdrawal of CDs. In our opinion, the Board's regulation still favors a single group of CD holders.

Maintaining liquidation accounts

Regulations for maintaining liquidation accounts have been implemented in various ways by savings and loan associations. This is sometimes in favor of the stockholders instead of the depositors for whom the account was established. The Board has issued new instructions which should correct this situation.

Under a mutual form of organization, the account holders (depositors) are the legal owners of an association. To prohibit windfall profits in a conversion, Board regulations require each converting association to establish a liquidation account equal to the converting association's net worth as of the latest practicable date prior to conversion. Upon any future liquidation of the association, the money remaining in this account would be distributed to the eligible account holders before any equity was distributed to the stockholders.

Board regulations describe generally the method an association should use in maintaining the liquidation account based on eligible account holder savings accounts, including CDs. The primary effect of the regulation is that eligible account holders who, at the end of each annual closing period, maintain accounts equal to or greater than their account balances at the eligible record date retain their ownership rights proportionately. The Board regulation further provides that if an account holder closes his account, he ceases to have an ownership interest in the association. His rights are transferred to the stockholders, who are the new owners of the stock association.

Savings and loan associations implement this regulation in different ways, sometimes to the advantage of the association stockholders:

--Most associations allow an account holder to maintain his liquidation rights when renewing a CD whose terms did not change. However, some associations terminate an account holder's ownership rights if the terms change.

--Some associations cancel owernship rights if an account holder transfers his money from a savings account to a CD or vice versa.

--Some associations cancel ownership rights if an account holder moves his money from one branch to another.

New instructions have been issued by the Board which, if properly implemented, should ensure that all account holders will retain their rights as long as their money remains in the association.

NEW STOCK PURCHASING RIGHT REGULATION NEEDS REVISION

Overall, the new regulations are a positive step towards making conversions equitable. However, one regulation could actually restrict wider participation in stock ownership. This regulation provides an imbalance in the amount of stock different categories of purchasers can purchase. Supplemental eligible account holders are entitled not only to purchase stock before it is offered to the community, but also to purchase a larger percentage of the outstanding stock.

Regulations provide for four categories for purchasing stock in the initial offering. These categories by priority are:

--Eligible account holders (anyone having a savings account at the eligibility record date, at least 90 days before the conversion plan is adopted by the converting association's board of directors). The amount of stock offered to each account holder is based on his/her deposit at the eligible record date, but limited to 5 percent of the available stock. All available stock is usually first offered to eligible account holders.

--Supplemental eligible account holder (anyone who has qualifying deposits at a predetermined supplemental eligibility record date). This is the last day of the calendar quarter preceding Board approval of a conversion application with an eligibility record date more than 15 months before the latest application amendment. The Board established a supplemental eligibility record date to allow more individuals to participate in subscription offerings of associations whose conversion plans have been subject to long approval delays. Supplemental eligible account holders are also limited individually to 5 percent of the stock offering. In addition, anyone qualifying both as an eligible and supplemental eligible account holder is limited in total to 5 percent of the stock offering.

--Other association members (any voting association member not included in the previous categories is entitled to purchase 200 shares to the extent that shares are available).

--Community offering (all remaining shares are offered to the community, but an individual may purchase no more than 2 percent of the stock offering).

Association management--directors, officers, and employees--may participate in the stock offering under any of the four categories. However, total purchases by this group cannot exceed 25 percent, nor may individual purchases exceed 5 percent.

Therefore, supplemental account holders, who may have advance knowledge of the association's conversion as association owners, have two advantages over community members: they can increase their savings deposits between the eligibility record date and the supplemental record date to buy additional stock before it is offered to the community and/or individually buy up to 2-1/2 times the amount of stock community members can buy. This limits the stock available to the community.

CONCLUSIONS

The Board's new regulations will help correct the inequities identified in early conversions and most of the problems identified in this review. However, we believe that some revisions to the regulations are still necessary.

We believe the Board should not give preferential treatment to certificate of deposit holders participating in stock subscription offerings. It is difficult to justify not imposing the early withdrawal penalty of CDs under conversion and at the same time penalize others for early withdrawal of CDs because of some other valid reason.

Some of the Board's proposed regulations promote the concept of wider participation in purchases of converting association stock. However, at the same time, we believe that one regulation concerning the amount of stock supplemental account holders may purchase tends to restrict this participation and needs to be revised.

RECOMMENDATIONS

Accordingly, we recommend that the Chairman, Federal Home Loan Bank Board, make the following changes to the conversion regulations:

- --Delete the regulations waiving penalties on the early withdrawal of certificates of deposit.

- --Reduce the supplemental eligible account holders' maximum allowable stock purchases from 5 to 2 percent of the subscription offering.

AGENCY COMMENTS

The Board stated that supplemental account holders' maximum allowable stock purchases would remain at 5 percent. They added that should the shifting of funds unfairly increase purchasing rights, the regulation will be amended to prevent any disruptive effects.

The supplemental account holder has the advantage of purchasing stock before the community and should not have the additional advantage of purchasing a larger percentage of stock if the objective of wide participation is to be achieved. Therefore, we believe that the supplemental account holder's maximum allowable stock purchase should be reduced to 2 percent.

The Board did not comment on our recommendation to delete the regulations waiving penalties on the early withdrawal of certificates of deposit.

CHAPTER 4

STOCK APPRAISALS--AN EVALUATION

Appraisals, which are an important part of the conversion process, often utilize the price/earnings (P/E) method for valuating savings and loan associations. Although this appraisal method itself appears appropriate for most associations, the Board often does not review or question inconsistencies in appraisers' applications of this method.

A savings and loan association is required to include an appraisal of the association with its application for conversion. The appraisal must be prepared by a person independent of the association, experienced in corporate appraisals, and approved by the Board. It establishes the value of the association which is then the basis for the stock price. Existing association owners/sellers (depositors) are often not concerned if an association is undervalued because they do not receive proceeds from the stock sale. Without the sellers' self-interest in deterring low valuations, there is a danger that an association could be undervalued. The Board's appraisal review should help deter this possible undervaluation.

REASONABLENESS OF APPRAISAL METHODOLOGY

Because the P/E methodology is generally accepted in the financial community, we believe it is a reasonable and appropriate methodology for most savings and loan association appraisals.

The Board is responsible for ensuring the reasonableness of the appraisals by reviewing and approving or disapproving each appraisal. To aid in this process, the Board issued "Guidelines for the Valuation of S&Ls Converting from Mutual to Stock Form of Organization, Including a Notice of Pre-filing Requirements for Appraisers." These guidelines recommend two methods for valuating associations--price/earnings and price-to-book-value.

In the P/E method, the appraiser values an association by first estimating the association's P/E ratio on the basis of P/E ratios of comparable savings and loan stock associations. Then the association's estimated market value is determined by multiplying its annualized earnings, including returns on conversion proceeds net of conversion expenses, by its estimated P/E ratio. The price-to-book-value method is similar to the P/E method, except that the association's price-to-book-value ratio replaces the P/E ratio, and the association's net worth book value is substituted for its annualized earnings.

Of the 32 appraisals we reviewed, the P/E ratio method was used in 31 instances. We could not determine the method used in the other appraisal. Financial experts indicated the P/E ratio method is widely used and accepted in the financial community. As a result, we limited our efforts to the P/E method.

Most criticisms of the P/E method are unfounded

The Board and conversion critics have questioned the appropriateness of using the P/E method for valuating savings and loan associations. Although the Board's limited criticisms appear valid, we believe the critics' positions are not substantiated.

The Board generally accepts the use of the P/E method. However, it believes its use is inappropriate in two instances. First, it tends to undervalue newly formed associations because of limited earnings experience. The Board is conducting a study to develop a more appropriate method for valuating these associations. Second, it should not be used for associations with negative earnings records. These appear to be appropriate concerns, since the P/E method is based on projected earnings.

Conversion critics challenge the use of the existing P/E ratio for a number of reasons. In our first report, we discounted criticisms that appraisals do not consider an association's potential to sell to a holding company after it converts and that an association's existing net worth is ignored in any appraisal method using future earnings. Three additional criticisms and our evaluation of them are as follows.

First, although critics state that a leveraging factor is not considered, appraisers make adjustments for this factor. Leveraging is the value given to the income that will be derived from investing new savings supported by the influx of new money (conversion proceeds) into a savings and loan association. In the 16 appraisals reviewed in depth, we noted that appraisers had considered the new money and the leveraging factor when they calculated the P/E ratio. For instance, six appraisers felt the association's growth would be fairly close to the average of comparable associations and thus did not adjust the P/E ratio on the basis of growth. Seven other appraisers assigned premiums of up to 25 percent to the converting associations' P/E ratios for their expected new money.

Secondly, critics say the postconversion P/E ratio should be higher than the ratios the appraisers have been using because of the large influx of new money into the converted associations. The addition of the new capital has two effects--increasing the net worth and providing "free" money for investments. Board analysis showed that for the 29 associations converted as of December 31, 1977, the average net worth before conversion was about 4 percent of savings. After conversion, it was 7 percent, which is identical to the average net worth of all Federal Savings and Loan Insurance Corporation insured State stock associations. Because the average net worth as a percent of savings for the converted associations and all stock associations are the same, we reject the argument that P/E ratios for converting associations should be higher than that currently used.

Finally, because the P/E method does not include an amount resulting from control blocks of stock, critics contend that associations are undervalued. We believe that (1) inclusion in all appraisals of an amount for control blocks of stock may overvalue those associations without control blocks of stock, and (2) certain factors, such as ownership diversity and restrictions on sale of stock by management, minimize any effect when control blocks exist.

Control is defined in the Financial Institution Regulatory and Interest Rate Control Act of 1978 as owning 25 percent or more of the stock. Appraisers do not assign a value for control shares of stock. Purchase of control is never assured because Board regulations require that all savers/members of an association be given the opportunity to purchase stock.

If all savers/members participated, then one individual could not acquire control. In the theoretical sense, this is true. However, statistics show that for conversions, where the data on management holdings was available, an average of only 3.8 percent of the saver/members purchased stock. According to the Board, as of December 31, 1977, management had acquired stock control in 22 of 29 converted associations. This lends support to the critics' argument that management will regain control soon after conversion. On the other hand, our analysis showed that in seven of these associations, management gained control through stock purchases or transfers in the secondary market and not in the initial subscription issue. In cases where management does obtain control, the Board attempts to minimize this impact by restricting management from selling stock obtained in the initial subscription issue for 3 years.

APPLICATION OF APPRAISAL METHODOLOGY

Although appraisers use subjective judgment in making appraisals, particularly in selecting savings and loan association comparables and applying discounts or premiums to an association's P/E ratio, the Board does not often examine the basis for appraisers' different judgment calls.

Board guidelines provide a specific formula to determine an association's fair market value using the P/E method. Four factors in the formula, each requiring appraiser subjectivity, are (1) an association's assumed P/E, (2) "normal" annual earnings base, (3) net after-tax rate of return on conversion proceeds, and (4) anticipated conversion expenses.

The amount of appraiser subjectivity depends on the factor involved. Regulations categorize conversion expenses into 11 items, such as legal, printing, and advertising. The value of these items can be easily determined.

Determining an association's assumed P/E ratio, however, requires subjectivity at two levels. The assumed P/E is derived by using the average of comparable savings and loan stock association P/Es adjusted for specific characteristics of the association being valued. Subjectivity is then first used in selecting comparable associations on the basis of asset composition, location, and size.

Once a P/E is computed on the basis of the comparable associations, the appraiser considers if any adjustments to the P/E are necessary because of specific characteristics of the association being valued. Adjustment--either premiums or discounts--may be based on up to 11 factors, including earning capacity, book value and financial condition, dividend policy, plans for the future, and marketability of stock to be issued.

Inconsistencies in applying appraisal methodology

Our review of 16 appraisals showed many inconsistencies in the comparables selected by the appraisers. We also noticed various applications of premiums and discounts to the P/Es derived from the comparables.

Association A, whose size was over $500 million, was used as a comparable by the appraisers of three converting associations whose sizes were about $15, $50, and $300 million. In contrast, the appraiser of a fourth converting association, whose size was about $150 million, stated that association A was too large to be used as a comparable. All these appraisals were completed within 6 months of one another.

Association B, with a growth rate of 46 percent, was used as a comparable by the appraisers of two converting associations which had growth rates of 21 and 14 percent. On the other hand, another appraiser, who was valuating two other associations with growth rates of 20 and 18 percent, did not use association B because its growth rate was too high.

In two appraisals for small associations, eight of the largest savings and loan associations in the country were used as comparables. The appraiser agreed that using data from smaller associations, which was available, would have resulted in better comparability and less subjectivity. He therefore used smaller comparables for subsequent appraisals. Regardless of the guidelines requirement that important consideration be given to size in choosing comparables, the Board never questioned use of the eight large associations.

In another appraisal, the 15 savings and loan associations chosen as comparables had average assets of almost 9 times that of the appraised savings and loan, including two savings and loans almost 20 times larger than the appraised association. Moreover, the comparables included associations in California and Florida, despite the fact that the appraised association was in the Midwest.

It is common practice in the appraisal of privately held companies to discount their common share values below those of comparable publicly traded companies. The discount may vary depending on the individual premiums or discounts assigned to a number of factors, including liquidity, marketability, size of the company, growth rate in the primary market area, and anticipated cash dividend policy.

In 16 appraisals, 6 were discounted from 5 percent to 30 percent, 3 had no discounts, and the remainder did not indicate clearly if a discount was used. For some associations with discounts, the growth rate factor was actually given a premium. Some appraisals indicated the amount of discount or premium by factor, such as by growth rate, liquidity, or anticipted dividend policy. Other appraisals did not indicate the role of individual factors, making it difficult to analyze the basis and justification for the discount.

A Board official advised us that they do not question an appraiser's judgment, only his methodology and completeness. Instead, the Board evaluates the appraiser's competence and integrity and relies on the appraiser's judgment for the associaton's final evaluation.

CONCLUSIONS

Because the P/E methodology is generally accepted in the financial community, we believe it is a reasonable and appropriate methodology for most savings and loan association appraisals (with the possible exception of newly formed associations or those with deficit earnings).

Although the methodology itself is sound, current Board practices allow for appraisers' subjective judgments to go unchecked. The Board does not require documentation of rationale behind such judgments as selection of comparable associations and decisions to apply discounts to an association's estimated P/E ratio.

RECOMMENDATIONS

We recommend that the Chairman, Federal Home Loan Bank Board:

--Require appraisers to subtantiate and/or document their reasons for selecting savings and loan association comparables, applying discounts or premiums to an association's estimated P/E ratio, and any other subjective judgment.

--Review the adequacy of these judgments before final acceptance of an association valuation.

AGENCY COMMENTS

The Board concurred with GAO's recommendation and will require that all appraisals contain indepth substantiation of all judgmental questions.

CHAPTER 5

CAPITAL AVAILABILITY--SOME DIFFERENT APPROACHES

The major reason given by associations for converting to stock ownership is to improve their capital or net worth position. In our first report, we discussed several ways other than conversion to raise capital. These include sale of stock through the establishment of a public trust fund and sale of short, medium, or long term subordinated debentures.

Legislation has been introduced to permit savings and loan associations to include mutual capital certificates (subordinated debt) as part of their general reserves and net worth. These certificates would be subordinate to all savings accounts, savings certificates, and debt obligations. Use of subordinated debt as net worth could reduce the need for conversion by providing additional net worth.

One additional important area not previously discussed is the amount of net worth that associations are legally required to maintain and the Board's interpretation of this requirement. Depending on the definition of the requirement and how it is determined, the net worth requirement can affect an association's growth. There have already been a number of suggestions on how to change this requirement and the Board is looking at the alternatives.

Of these alternatives, two warrant special consideration by the Board and the Congress. These are the use of an asset-composition net worth requirement and a net worth requirement computation based on beginning-of-year account balances. If these changes are adopted, the need to rely on outside capital could be reduced, thus reducing the immediate need for some associations to convert.

HISTORY OF NET WORTH REQUIREMENTS

In the early thirties, as a result of the Great Depression, U.S. financial institutions were suffering large losses, and many went bankrupt. Naturally, the public credibility of the financial community was low. Associations were issuing only passbook accounts and had one primary type of investment--single family housing loans. Also, interest or dividends paid to savers was a function of earnings. Under these circumstances, the Congress enacted the National Housing Act of 1934, which established the Federal Savings and Loan Insurance Corporation and instituted a reserve or net worth requirement for savings and loan associations.

Specifically, federally insured associations were required to:

> "* * * provide adequate reserves, satisfactory to the Corporation, to be established in accordance with regulations made by the Corporation, before paying dividends to its insured members; but such regulations shall require the building up of reserves to 5 per centum of all insured accounts within a reasonable period not exceeding ten years, and shall prohibit the payment of dividends from such reserves, or the payment of dividends if any losses are chargeable to such reserves."

As a result, the Board required each association to establish a Federal Insurance Reserve (FIR) solely for absorbing losses, and annual FIR credits were to be based on a percentge of the association's total insured savings accounts as of the beginning of the fiscal year. Within 10 years, the credits were required to equal 5 percent of the association's insured savings accounts.

Through the years, revisions have been made to both the National Housing Act and the Board's regulations. Changes to the National Housing Act include:

--Accumulating a 5-percent minimum reserve requirement over a 20-year period instead of 10 years.

--Requiring Federal Savings and Loan Insurance Corporation approval for an association to pay dividends when losses were chargeable to the FIR.

--Increasing minimum reserve requirements up to 30 years on an optional basis.

Revisions to the Board's regulations are numerous. Until 1956, changes dealt only with meeting the FIR and included reducing the required annual credit, extending the time for associations to meet reserve requirements up to 20 years, and earmarking funds, such as undivided profits, to meet reserve requirements.

In 1956, the regulations were revised to include in addition to the FIR, a net worth requirement based on a percentage of all insured savings accounts. This requirement was added to further increase the reserves of an association. In the years that followed, association ratios of net worth to savings were declining; slow assets, such as delinquent loans and foreclosed real estate were rising; and dividend rates were rising.

These factors were prevalent at many associations, increasing risky assets while diluting net worth. This gave rise to a new method of computing the minimum net worth requirement. Instead of being the FIR plus a percentage of all insured savings accounts, the net worth requirement became the FIR plus a percentage of certain assets. Also, computations were now based on yearend account balances instead of beginning-of-the-year balances. These changes occurred in 1964. Specifically, the changes included:

--In addition to the savings account percentage requirement, semiannual credits to FIR based on specified asset growth except when adjusted net worth is at least 12 percent of the association's specified assets at the end of the semiannual period.

--Net worth required to be equal to the FIR plus 20 percent of scheduled items as of the closing dates preceding and following the insurance anniversary date. Scheduled items are loans or investments having a poor repayment record, or real estate owned as a result of foreclosure or sold on substandard terms.

--FIR computed on the savings account balance at the end of the year instead of the beginning of the year.

In 1966, the Congress authorized a comprehensive study of the savings and loan business. One study paper by a Harvard University faculty member concluded that associations were required to maintain reserve accounts to protect depositors--a role of the Federal Savings and Loan Insurance Corporation's insurance fund--when in fact reserve accounts should be designed to reduce institution failures.

An in-house study by the Board and a U.S. Savings and Loan League study took the position that capital adequacy should be based on asset composition and quality rather than savings. Finally, another in-house Board study, completed in 1971, showed that the FIR could be counter-productive. Many associations were unable to meet reserve requirements from current earnings. As other reserves were stripped to meet the FIR, associations faced reduction in savings activity, adversely affecting the home mortgage market.

ESTABLISHMENT OF CURRENT REGULATIONS

The Board revised its regulations, effective December 15, 1972, to reflect the concerns of capital adequacy in terms of asset risk. These regulations (CFR Title 12, 563.11-563.13), which are basically the ones used today, provide for:

--An FIR account balance equal to a percentage (graduated annually) of the institution's savings accounts on the closing date following the institutions insurance anniversary date, or the average of the savings accounts on this and one or more of the four immediately preceding annual closing dates, provided it is equal to at least 5 percent of the savings accounts on one anniversary date prior to the 26th anniversary.

--Earmarking association accounts to satisfy the FIR requirement. These accounts include pledged savings accounts, capital stock when permitted by State law, capital surplus, contributed surplus, or retained earnings.

--A net worth requirement, the greater of the FIR account plus 20 percent of the institution's scheduled items, or the amount determined under the asset composition and net worth index, on the annual closing date following the institution's insurance anniversary date. The asset composition and net worth index is based on specified graduated percentages of 26 asset classes.

Basing net worth requirements on asset composition

One means of changing the net worth requirement is to eliminate the FIR and base the total net worth reserves on an association's asset composition index. This could reduce net worth requirements, thereby reducing an association's need for capital.

In 1977, Federal Savings and Loan Insurance Corporation data drawn from 3,803 of 4,065 insured associations showed that 835 associations (22 percent) based their net worth requirements on the asset composition index, while 2,968 based their net worth requirements on the FIR computation, since it was larger than the asset computation. However, if all 3,803 associations used the asset composition index computation, their net worth requirement for 1977 would have been reduced by approximately $1.72 billion, or 12 percent. This reduction would occur mostly in mutual associations.

Two 1978 study reports, a Northwestern University study report commissioned by the Federal Savings and Loan Insurance Corporation entitled "A Study of FSLIC Risk Management in a Changing Economic and Regulatory Environment," and their own study report entitled "Analysis of Federal Insurance Reserve/Net Worth Condition of the Savings and Loan Industry," concerned risk in the savings and loan industry. These reports concluded that the FIR is an inferior form of net worth in relation to the risk-bearing capacity of the savings and loan industry.

Both reports indicated that eliminating the FIR and substituting a total net worth requirement based on an asset composition would have no adverse impact on an association's ability to absorb risk. Under this approach, the association's risk would be placed on assets--the theory being whether an association has good assets and/or its reserves are based on poor assets, it would maintain its ability to repay savers when they withdraw their savings.

Although an asset-based index net worth requirement seems sound for insuring associations against such inherent risks as insolvency, neither study believes the Board's asset computation is an acceptable final solution because the various asset categories may not be weighted correctly. However, both studies stated that some asset-based index should be used. On this basis, the university study sponsored by the Federal Savings and Loan Insurance Corporation recommended the elimination of the FIR requirement.

In February 1978, the Board Chairman established a net worth policy committee to develop recommendations concerning the possible elimination of the dual FIR/net worth requirement and the adoption of an asset based net worth requirement. This committee's work was generated by the Northwestern study. In a March 1979 report, the committee recommended that the dual FIR/net worth requirement be eliminated and a new net worth requirement established. Committee members differed concerning the basis of the net worth requirement. Some members advocated basing the requirement on the previous FIR plus a percentage of scheduled items and on secured borrowing. Others recommended using only an asset-based index.

As a result of the policy committee report, the acting Board Chairman requested that an asset composition index be developed.

Determining net worth requirement at the beginning of the year

When the Board first established the FIR (net worth) requirement in 1934, it was based on beginning-of-the-year account balances. During the next 30 years, revisions were made to the net worth requirement, but computations continued to be based on beginning-of-the-year account balances.

The Board amended its net worth requirements in 1964 and required that an additional amount be added to the FIR account. Each association was required to make a semi-annual credit to the FIR account of 10 percent of its net income for the period. At the same time, computation of net worth requirements was changed to using yearend account balances.

This change generally caused an increase in the total reserve requirements. In 1972, net worth requirements were revised to utilize the asset composition index and eliminate the semiannual credit to the FIR. However, all net worth requirements have continued to be based on yearend account balances.

The Board's net worth policy committee has recommended that net worth requirements be based on a time lag such as beginning-of-the-year account balances instead of yearend account balances. By knowing the net worth requirement at the beginning of the year, association management can more effectively manage its assets during the year.

CONCLUSIONS

An association's capital adequacy is dependent upon its net worth requirement. Through the years, the Board shifted the net worth requirement from a percentage of insured savings accounts to the larger of either a percentage of insured savings accounts or composition of assets index. Since an association's risk is directly related to the composition of its assets, it appears that an asset-based index would be a reasonable method to use to determine an association's net worth requirement. This could reduce an association's capital requirements where the bulk of its assets are sound. At the same time, it could increase the capital requirement of associations whose assets are in relatively poor shape.

This approach seems also to provide incentive for good management (lower reserves) while penalizing poor management through higher reserves. Under the present method, the influx of new savings is not the real indicator of good management. It is how assets are handled. In addition, our review showed that the net worth computation requirement is based on yearend account balances. This makes it difficult for the association management to effectively plan for net worth requirements, since they are not known until the end of the year. Initially, Board regulations established that net worth requirements would be based on beginning-of-the-year account balances. The beginning-of-the-year account balances could be used to determine an association's net worth requirement, since management's efficiency in meeting the net worth requirement would be improved without adversely affecting an association.

RECOMMENDATION

To assist the Congress in establishing a national policy on conversions, we recommend that the Chairman, Federal Home Loan Bank Board, provide the Congress with the Board's new definition of association new worth requirements when developed.

AGENCY COMMENTS

The Board did not comment on our recommendation.

CHAPTER 6

ACCOUNT HOLDERS' VIEWS ON CONVERSION

At the Chairman's request, we sampled the public's attitude toward conversion. We obtained a random sample of 647 account holders from four converted associations located in different geographic areas of the United States. We initially mailed a questionnaire to each account holder, all of whom had been involved in the conversion process. To improve the survey response rate, we conducted two followup mailings.

Of the 647 account holders queried, 425 responded and their responses were used. The remaining 222 questionnaires were either undeliverable (65) or not returned.

Since our sample was limited to four savings and loan associations, the results may not be applicable to all converted savings and loan associations.

The questionnaire was designed to solicit account holders' attitudes toward conversion, as well as to determine whether account holders

--actually understood conversion,

--were for or against conversion and why,

--would favor conversion if they were members of other mutual savings and loan associations planning to convert today,

--purchased conversion stock and why, and

--would purchase stock today if given the opportunity (although they had not purchased stock originally) and why.

In general, on the basis of answers to several questions, we noted that about 50 percent of the account holders either did not understand the conversion issue or simply were not interested in conversion. Although most of the 425 respondents indicated they had received information about their savings and loan associations' conversions, the majority had not bothered to vote on the issue.

Nearly 33 percent of the respondents indicated that they were in favor of conversion; a little more than 10 percent were against conversion; and most of the remainder were not interested. The reasons most frequently given for favoring conversion were the chances to make a good investment and to earn dividends. The reason most often given against conversion was the account holders' concern that they would lose ownership rights unless they purchased some stock.

Generally, our survey showed that a person favoring conversion was more apt to purchase stock than a person against conversion. For example, a little more than 20 percent of those who favored conversion purchased stock, as did approximately 5 percent of those who were against conversion. The reason most often cited for purchasing stock was investment purposes. Major reasons cited for not purchasing stock when the opportunity was presented were the account holder's

--lack of funds to invest, and

--belief that management would be gaining control of most shares of stock.

FINANCING STOCK PURCHASES

The Chairman also asked that we determine how depositors financed their stock purchases. Although we did not request this information in our survey, we examined Board records and discussed the matter with association officials. The results follow:

--In 29 converted savings and loan associations between 20 and 93 percent of the total gross proceeds attributable to stock purchases by association members came from savings accounts and certificates of deposit. This amounts to 59 percent for all 29 associations.

--Board records show that in some instances management has used the stock as collateral and borrowed money from banks to finance their purchases. In other instances, personal assets, such as homes and businesses, were used as collateral. We made no attempt to determine how the funds were obtained when private funds were used.

CHAPTER 7

SCOPE OF REVIEW

We made our review at the Federal Home Loan Bank Board headquarters, Washington, D.C., and at nine savings and loan associations in Florida, Maryland, Kansas, California, and Virginia. Since we had previously reviewed eight associations, we merely updated our information on these associations.

We reviewed Board regulations, guidelines, records, and reports, and interviewed Board officials. We examined association records and interviewed management. We also interviewed officials in the appraisal business and other related businesses about their roles in and views on savings and loan conversions.

United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, D.C. 20510

May 17, 1978

The Honorable Elmer B. Staats
Comptroller General
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Staats:

As you know, the Committee on Banking, Housing and Urban Affairs is interested in the issue of conversions of savings and loan associations from the mutual to the stock form of organization. The General Accounting Office has completed an audit of eight conversions which noted weaknesses in the Federal Home Loan Bank Board's conversion program and processes. Recently, the Council of Mutual Savings Institutions completed a study which showed significant abuses in such conversions. Both these reports justify additional auditing of the reasonableness and desirability of continued conversions by the GAO.

Therefore, I would like you to expand your audit beyond the eight conversions completed to include additional conversions approved by the FHLBB to date. The areas that should be considered and reported to the Committee at a minimum along with the matters raised in my letter to you dated July 13, 1976 are:

1) The effectiveness of FHLBB regulations in minimizing the advantages to insiders.

2) A determination of how depositors are financing their purchases of stock and a sampling of depositors attitudes on conversions and the conversion process.

The Honorable Elmer G. Staats
Page Two

3) A review of the appraisal methodology on all completed conversions from October 1, 1976 to date compared to the first eight conversions along with an analysis of the inherent fairness of the appraisal process.

4) A determination of how well liquidation rights have been established and protected and accounted for in the converted associations.

The requested expansion of audit effort relating to the number of conversions and the areas to be reviewed will be helpful to the Committee in evaluating the conversion issue in the future. The staff of the Committee on Banking, Housing and Urban Affairs is available for continued discussions and answers to any questions that may arise. I appreciate your cooperation and thank you in advance.

Sincerely,

Bill Proxmire

William Proxmire
Chairman

WP:lmg

United States Senate
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
WASHINGTON, D.C. 20510

July 13, 1976

The Honorable Elmer Staats
Comptroller General
General Accounting Office
Washington, D. C.

Dear Mr. Staats:

The Federal Home Loan Bank Board (FHLBB) recently filed an interim report with the Committee on Banking, Housing and Urban Affairs concerning its responsibilities to conduct a study of a limited number of conversions of savings and loan associations from the mutual form of organization to the stock form of organization.

PL-93-495 (12 U.S.C. 1725 (j)) authorized the FHLBB to permit a limited number of experimental savings and loan stock conversions in order that Congress would be in a position to assess whether or not such conversions could be permitted on a basis consistent with the public interest. The FHLBB has thus far approved 10 conversions and its interim report contains various data concerning these conversions. The Committee recently approved a one year extension of time for the FHLBB to conclude the experiment.

Conversions from the mutual form of organization to the stock form of organization raise a number of highly significant issues. The most important of these is whether it is feasible to place these mutual business enterprises into private hands without enriching insiders at the expense of the savers who contributed to the institution's equity.

The interim report of the FHLBB concludes favorably that the conversion process works in an effective and entirely satisfactory manner. However, there is no substantial evidence in the FHLBB report that supports this conclusion.

An important area for study and inquiry by the FHLBB should be the price at which shares in the converting institution are sold to investors. The report of the FHLBB on the 10 conversions completed to date reveals that the price at which shares have been sold to the public were arrived at with considerable application of judgment by the appraisers.

Honorable Elmer Staats -2- July 13, 1976

Since in many cases the appraiser has a strong interest in the sale of the shares, a substantial risk is presented that the appraiser's judgment will be exercised in setting a price low enought to result in the sale of all shares rather than at a price which reflects the real worth of the mutual enterprise. A corallary incentive is that conversions will take place when the market for stocks generally is depressed in anticipation of early gains by those who buy.

My review of the interim report of the FHLBB compels me to request that the General Accounting Office conduct a full audit of the management by the FHLBB of the Congressional mandate under PL-93-495.

The audit should provide an analysis of the following matters in addition to a thorough review of the conversions which have been permitted to date:

1) The extent to which the regulations and procedures of the FHLBB fulfill the statutory mandate to conduct the conversion experiment;

2) Whether the methodology and procedures of the FHLBB relating to appraising the value of converting mutual institutions insure a fair price;

3) The extent to which the price at which shares have been sold in the conversions completed to date are reflective of the recommendations contained in the underlying appraisals;

4) The extent to which the appraisals have been based upon objective factors in arriving at the evaluations to date as distinguished from reliance on subjective factors or "judgments";

5) The extent to which appraisers have had a direct or indirect interest in the sale of shares in the converting institution and any actual or potential areas of conflict of interest which are apparent;

6) The extent to which conversions permitted by the FHLBB benefit insiders such as current management or shareholders at the expense of increased public participation in conversions;

7) The extent to which a transfer of the existing equity in a converting institution to a public trust has been examined as an alternative method of proceeding by the FHLBB in experimenting with conversions;

Honorable Elmer Staats -3- July 13, 1976

8) Respecting the analysis requested covering the conversions permitted to date, a thorough financial analysis should be provided including:

--An analysis of the price/earning ratio at which shares were sold in converting institutions and a comparison analysis of the price/earnings ratio at which sales of shares in similar institutions are traded in the market place.

--An analysis of the price in relation to book value for which shares in stock savings and loan associations were acquired during the past five years and a comparison analysis of the price in relation to book value for which shares were acquired in converting institutions.

--An analysis of dividend and share payout rates at converting institutions before and after conversions.

The staff of the Committee on Banking, Housing and Urban Affairs is available to discuss any questions that may arise in the conduct of the requested audit.

I thank you in advance for your continued cooperation with the work of this Committee.

Sincerely,

William Proxmire
Chairman

WP:lmg

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporat

July 16, 1979

Allen R. Voss, Director
General Government Division
United States General
Accounting Office
Washington, D. C. 20548

Dear Mr. Voss:

On June 7, 1979, you submitted for Chairman McKinney's consideration and comment the latest draft of the proposed General Accounting Office ("GAO") report on the Federal Home Loan Bank Board's ("Bank Board") mutual to stock conversion program. As Mr. McKinney has resigned as Chairman and in order that the Bank Board may respond in a timely fashion I have endeavored to respond to the draft report.

Overall, I believe, the report approaches the subject from a fair and balanced position. I was particularly pleased with GAO's determination that "conversions have been both successful and financially rewarding", an opinion I have held for sometime. Since the Bank Board's position with respect to the conversion program has been stated repeatedly over the past two years in reports to Congress, letter opinions to Senator Proxmire and memoranda to various interest groups, I shall limit my comments to those sections of the report with which I take exception and to several positive aspects of the program which, in fairness, should be presented.

The most significant finding made by the GAO is the need for Congressional action. According to the GAO, two fundamental policy questions must be considered by Congress. First, a national policy on conversions must be established, i.e., Congress must consider whether savings and loan associations should be allowed to convert from mutual to stock form of ownership. Second, clarification of the Bank Board's authority to permit federal associations converting to the stock form to retain their federal charters is needed.

Allen R. Voss, Director
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Congress has considered the question of whether savings and loan associations should be permitted to convert to the stock form of organization on three separate and distinct occasions and has determined that these institutions should have such authority. Congress first addressed the question in 1948 by amending Section 5(i) of the Home Owners' Loan Act of 1933 to explicitly authorize the conversion of federal associations into state associations, including a stock association, upon an equitable basis, subject to the approval of the Bank Board.

The conversion issue was considered a second time by Congress in 1973 at the behest of then Bank Board Chairman Martin. Chairman Martin was most concerned with the Bank Board's authority to continue the administratively imposed moratorium, especially in light of the extensive studies conducted and the number of conversion applications filed. Congress responded to this concern with the enactment of Public Law 93-100, which, among other things: (1) imposed a limited Congressional moratorium until June 30, 1974, and (2) authorized the Bank Board to adopt rules and regulations governing mutual to stock conversions for federal and FSLIC-insured state associations.

On February 28, 1974, the Bank Board adopted its sale of stock conversion regulations. However, two serious problems still had to be faced. First, there was a danger of an erosion of the federal savings and loan system because federal associations could convert to stock associations only by obtaining a state charter. Second, although the Bank Board believed it had general authority to regulate conversions of FSLIC-insured state mutual associations to insured state stock associations, it was concerned over the exercise of this authority in light of the absence of a specific statutory provision governing such conversions. This lack of specific statutory authorization raised some doubt as to Bank Board's ability to regulate such conversions. In order to resolve these concerns, the Bank Board sought legislative clarification of these problems.

Congress responded by passing Public Law 93-495, which was enacted on October 28, 1974. This statute specifically reaffirmed the Bank Board's authority to adopt rules and regulations governing conversions of all insured institutions and authorized federal mutual associations to convert to federal stock associations except where state law prohibited state stock associations.

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Additionally, Public Law 93-495 amended the definition of the term "reserve" under Section 403(b) of the National Housing Act to include capital stock. Section 105 (b) and (c) of Public Law 93-495 also transferred the responsibility for the regulation of securities issued by insured institutions from the Securities and Exchange Commission to the Bank Board. These measures were part of the establishment of a permanent framework for the Bank Board's regulatory authority over all stock associations. Thus, Public Law 93-495 was designed by Congress to meet very specific regulatory concerns that had arisen over the years by providing a permanent statutory framework for federal stock and state stock conversions.

In sum, I must take issue with the GAO contention that Congress has not established a national policy on the right of federally chartered or FSLIC-insured associations to convert. Rather, Congress clearly intended that savings and loan associations should have the right to convert and that the Bank Board should be charged with assuring the equitability of such conversions.

The second fundamental policy question which, according to GAO, must be considered by Congress is whether federal associations converting to the stock form should be permitted to retain their federal charters. The Senate Office of the Legislative Counsel and the Comptroller General of the United States are of the view that all of Section 402(j) of the National Housing Act expired on June 30, 1976, and that federal mutual savings and loans, after June 30, 1976, may no longer convert to the stock form of organization and retain their federal charters. The Bank Board strongly disagreed for the reasons set forth in a March 4, 1977, Bank Board opinion, a copy of which has been sent to you. This opinion was reaffirmed by General Counsel Jones in a memorandum dated March 13, 1978.

Notwithstanding, I am mindful of the impact which the Comptroller General's opinion has had on the question of the validity of federal stock conversions after June 30, 1976. It is unfair to leave the validity of the eighteen federal mutual to federal stock conversions approved since June 30, 1976, subject to any possible challenge. Moreover, it should be remembered that many of these eighteen conversions were approved before the question of the expiration of the Bank Board's federal stock chartering authority was raised. Thus, in my view, Congress has an obligation to clarify the federal stock chartering authority not only to the eighteen federal stock associations but also to the thousands of stockholders who have invested their funds in these associations, to the members of associations which have filed applications to convert to the federal stock form and the general public.

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I was pleased that the GAO was of the opinion that the Bank Board in amending its conversion regulations had made "great strides" and that these regulations were "equitable". As you may know, upon assuming my position as Board Member, I informed Senator Proxmire that I was fundamentally committed to strengthening and improving the conversion procedures and to doing everything feasible to make them as equitable as possible. In this connection, Chairman McKinney and I instructed the staff, in accordance with the recommendations made by the GAO, to develop and implement new programs and procedures to monitor conversions so as to assure that our regulations are being adhered to by converting and converted associations. In addition, we directed the staff to reassess the regulations in light of the GAO report and the conversion experience to date. After careful consideration of the GAO and staff recommendations the Bank Board put out for comment proposed amendments to the conversion regulations. As you may know, these regulations were adopted with limited changes on March 21, 1979. It is my firm belief that these new regulations provide even more assurance of the equitability of the conversion process. Several new provisions which have had a dramatic impact on the conversion process are the limitation on stock purchases by individuals at 5%, the limitation on purchases by management in the aggregate at 25% and the requirement that shares not sold to members be offered to the community and the public rather than be privately placed.

The GAO, although of the opinion that the conversion regulations have been greatly improved, believes additional changes are needed. Specifically, the GAO believes the Bank Board has been too liberal in granting subscription rights to the most recent depositors of associations i.e., supplemental eligible account holders. The Bank Board permits these depositor-members to purchase up to 5% of the offering; on the other hand, the GAO would limit these subscription rights to 2%. The Bank Board increased the purchasing rights of these most recent members in order to broaden and increase participation in the subscription offering. However, should the Bank Board discover, as the GAO fears, shifting of funds to unfairly increase purchasing rights the regulation will be amended to prevent any disruptive effects.

A significant aspect of the most recent GAO review of conversions is an analysis of the appraisal process employed by converting associations. The GAO has recommended that more documentation and justification be required for several factors which require judgmental determinations by the appraiser. I fully concur and the Office of Economic Research, charged with reviewing the appraisals, shall now require in depth substantiation of all judgmental questions.

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Nevertheless, it must be remembered that valuation of a savings and loan association is to a certain extent subjective. The Bank Board has required documentation, never before required in valuations of any sort, even by the Internal Revenue Service or the Securities Exchange Commission. The Bank Board has developed a "formula" that contains four key valuation factors. Notwithstanding, this formula cannot be mechanically applied, as the GAO report suggests. Appraisers must interpret and apply the basic appraisal principles, including change, substitution, contribution, and anticipation. Because of the necessarily interpretive process of appraisal, the apparent "inconsistencies" pointed out in the GAO report are actually anomalies brought about by the intricate nature of the securities appraisal and distribution process. Although, I disagree with many of the GAO's criticisms of the appraisal process, I assure you the Bank Board will continue to develop an appraisal review process which will further assure the fairness and equitability of the conversion process.

A primary reason associations are converting from mutual to stock form is to avail themselves of additional capital. An association which is experiencing capital adequacy problems can relieve this condition by infusing through conversion permanent equity capital. Moreover, stock associations can go forward with subsequent stock issuances should additional capital be needed. The GAO has questioned whether associations which are not experiencing or imminently about to experience regulatory net worth defiencies should be permitted to convert. The right to convert, however, is not a right conditioned upon net worth defiencies. There is nothing in Section 5(i) of the Home Owners' Loan Act or Section 402(j) of the National Housing Act that would justify such action. The imposition of such a limitation would not only be contrary to the intent of Congress but would represent an overreaching encroachment on the private sector by the Bank Board. The members of a savings association, in my opinion, should have the right to decide the form of organization the association shall ultimately take.

In conclusion, I should like to reaffirm my commitment to insure that conversions be conducted fairly and in such a manner as to serve the public good. I hope that these comments will be useful to you in your analysis of the draft report.

Sincerely,

Anita Miller

Anita Miller
Acting Chairman

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