INTRODUCTION

This Section will help you recognize the unique issues presented by a mutual holding company (MHC) structure. An MHC structure is fundamentally different from a traditional savings and loan holding company structure. An MHC structure combines the elements of a mutual thrift, which is owned and controlled by its depositors and, in some cases by its borrowers, with elements of a stock thrift and holding company.

An MHC is the result of a conversion of a mutual institution to become a stock institution. The MHC becomes the corporate repository of the mutual members' economic and legal interests. It must own a controlling interest in the newly created stock institution, but it may sell up to 49.9% of the institution's voting stock, as well as any nonvoting stock, as a means to raise capital. Even when there is no issuance of stock to the public, there is still stock that has been issued to form the structure.

Not all MHC structures will look the same. In all cases, the thrift becomes a stock institution. Some structures will include a mid-tier stock holding company between the stock thrift and the MHC.[1] Other structures will include only the stock thrift that is directly owned by the MHC.

By creating the MHC structure in 1987, Congress provided an alternative to a full conversion from a mutual to stock form.[2] It provides a means for the members to continue to influence and control the operations of the institution, while also providing a means to raise capital. Mutual institutions that traditionally had little choice but to accumulate capital through retained earnings can use the MHC structure to sell minority stock interests.[3] The MHC structure can also be used as a vehicle to engage in activities under the holding company umbrella.

The guidance in this Section will help you assess the risks that the MHC structure poses. You must consider the combined risk profile, financial health and stability of the consolidated enterprise, the influence of minority shareholders and the degree of interdependence between the thrift, a mid-tier stock holding company (if one exists), and the MHC. You should base your examination conclusions on the current and prospective effect the structure has on the subsidiary thrift.

EXAMINATION COMPONENTS

The MHC form of organization may affect your examination steps. In addition to the standard examination procedures used for a stock holding company, you should evaluate the following unique areas of concern presented by an MHC.

Capital

As noted in Section 300, OTS does not have a standardized capital requirement that applies to all holding companies. Instead, capital is evaluated on a case-by-case basis determining the amount of capital necessary to support the risks within the structure.

Dividend Waivers

To allow more capital to remain at the thrift, thereby increasing the capital position of the thrift, an MHC may waive its right to receive a dividend. Needless to say, this has an impact not only on the thrift, but also on the level of capital at the MHC available to support its other activities. Prior notice must be provided to OTS.

[1] A mid-tier stock holding company exists between the parent MHC and the thrift. The majority of shares in the mid-tier stock holding company must be issued to the MHC, and the mid-tier stock holding company must own 100 percent of the shares of the subsidiary thrift.

[2] An MHC may subsequently decide it wants to pursue a full conversion. This later action also requires OTS approval, and is referred to as a second step conversion.

[3] While mutual institutions may receive pledged deposits and issue mutual capital certificates and subordinated debentures, they rarely use these options.

Dividend waivers must not be detrimental to the safety and soundness of the subsidiary thrift. Dividend waivers also require a board resolution that the waiver by the MHC is consistent with the directors' fiduciary duty to the mutual members.

The waiver of dividends by the MHC allows for any dividend declared by the thrift to be distributed only to the minority shareholders. The potential for a conflict of interest exists when directors and officers are deciding whether or not to waive dividends. If the directors and officers also hold stock, the financial decisions they make may personally benefit them. You should determine if the waiver has unduly enriched the minority shareholders at the expense of the MHC members.

The waiver of dividends may also result in atypical per share results. Earnings per share calculations are made using all outstanding shares, both those held by the MHC and the minority shareholders. On the other hand, dividends per share calculations are typically made using only the number of shares that will receive dividend payments. If the MHC waives its right to a dividend, this will result in a calculation using only the number of outstanding minority shares. For example, assume net income of $20 million, dividends of $9 million on the 4 million shares owned by the minority shareholders, and dividends waived on the 6 million shares owned by the MHC. Earnings per share are $2.00 ($20 million /10 million shares). Dividends per share are $2.25 ($9 million /4 million shares). From these ratios, it might appear that dividends exceeded net income ($2.25 per share vs. $2.00 per share), when in fact dividends were only 45% of net income ($9 million/$20 million).

Organizational Structure

As discussed in Section 400, many thrift holding companies operate without activity restrictions. However, ***all MHCs and their subsidiaries are subject to activity restrictions***.[4] An MHC may engage in the same activities as a stock holding company subject to activity restrictions[5]. The permissible activities for holding companies subject to activity restrictions are outlined in Section 400.

Relationship

A unique aspect of the MHC structure is the ownership of the MHC by the members. This group may exhibit little interest in the activities that occur and may not realize their potential for involvement in the organization. The structure may operate with a small group of individuals exercising exclusive control over the entities within the structure.

Board Responsibilities

The existence of an MHC, and possibly a mid-tier stock holding company, adds complexity to the structure.

The boards of directors of the thrift, mid-tier holding company (if one exists) and MHC may be comprised of the same, or mostly the same members. However, you should ensure that the boards of directors of each entity in the structure operate independently. The boards of each organization have distinct responsibilities. Each entity must maintain a separate corporate identity and interrelationships among the companies should not be detrimental to the institution. MHCs and mid-tier boards may meet less frequently than thrift boards because they are typically shell entities. You should evaluate how effectively each Board operates in executing its duties and responsibilities. The interests of one entity in the structure should not be sacrificed for the benefit of another entity in the structure.

You should review board minutes to determine if adequate discussion and analysis of issues occurs at each level in the structure.

[4] 12 CFR § 1467a(o)(5).

[5] 12 CFR § 575.11.

Minority Shareholders

The addition of minority shareholders into a traditional mutual environment may result in change for the thrift. Minority shareholders, particularly those elected to the board of directors, may bring a fresh perspective from experiences in other organizations or industries. This additional perspective may help the organization to identify new ideas and enhance the thrift's potential for long-term growth. Minority shareholders may also create friction within the organization. A focus on dividends may result in unreasonable demands for increased earnings or dividends that may weaken the capital position of the subsidiary thrift.

Minority shareholders may call for activities that increase shareholder value through the sale or merger of the thrift with another institution. This may result in the board and management focusing on trying to appease shareholders rather than focusing on activities in the long-term best interest of the structure.

An option available to MHC's is a second step conversion. This enables the entity to convert to a stock structure. OTS requires a majority vote of minority shareholders to approve any second step conversion.

Earnings

The Earnings section of this handbook provides a number of useful ratios for analyzing the financial statements of each entity in the MHC structure.

Pure mutual organizations may have the goals of customer service as a priority over profit maximization. The shift to an MHC structure, with the resulting influence of shareholders, may create pressure for increased earnings.

Financial Statement Analysis

Financial statement analysis in an MHC structure will include evaluations of statements of each entity in the structure. Intercompany transactions should be evaluated closely. Your examination should determine that transactions that occur are properly authorized, recorded and reported, and assess the direct or indirect impact on the thrift. Transactions that may appear appropriate when only one entity is reviewed, may appear questionable when both sides of the transaction are reviewed together.

There should be a tax allocation agreement between the MHC, mid-tier and thrift. The allocation should ensure that the thrift does not assume a larger tax burden than it would if it filed independently.

The allocation of revenues and expenses between the savings association, affiliates, and holding companies should be based on a documented method that is systematic, rational, and consistent with sound principles of corporate governance. In the absence of an appropriate allocation, reported earnings could be significantly different from that which would have been the case had there not been the intercompany relationships. You should question the allocation if it does not track with the earnings activities of, or the economic benefits derived by, the separate entities. For example, the allocation of all legal costs incurred by, and for the benefit of, the savings association to an MHC, which has no significant operations of its own, is generally not appropriate. As a result, earnings of the MHC would be understated, while earnings of the savings association would be overstated. Where minority shareholders are present in the structure, they would benefit, to the detriment of the MHC. This is because the MHC would effectively bear more than its pro rata share (based on ownership) of the savings association's legal costs.

SUMMARY

The MHC structure expands the options available to mutual savings associations. The structure allows the organization to maintain many of the features of a mutual while providing access to capital markets.

Consistent with the general holding company philosophy and supervisory approach, the examination of an MHC structure should consider the direct and indirect impact on the thrift institution. Furthermore, since the MHC is the repository of the mutual members' economic and legal interests, you should insure that the directors and officers of the MHC are properly fulfilling their fiduciary responsibilities.

REFERENCES

United States Code (12 USC)

§1467a(o) Mutual Holding Companies

Code of Federal Regulations (12 CFR)

Part 575 Mutual Holding Companies