National Credit Union Administration

October 12, 2005

Mr. Lee Bettis, Executive Director
Coalition for Credit Union Charter Options
500-5301 Wisconsin Avenue, NW
Washington, DC 20015

Re: Credit Union Charter Conversions.

Dear Mr. Bettis:

This responds to your letter to me, dated September 28, 2005, and seeks your cooperation in assuring that the interests of credit union members are served when their boards of directors consider a proposal to convert to a non-credit union charter.

Your letter charges that NCUA Regional Directors and I have made public statements suggesting that credit union conversions to other depository institutions may be motivated by credit union management's desire for personal financial gain. You assert that an objective credit union regulator should refrain from evaluating credit union corporate governance issues and business decisions regarding conversions. You conclude that NCUA opposes credit union conversions to mutual savings banks.

NCUA does not oppose a credit union's authority to convert to a savings bank or other non-credit union charter. On the contrary, our objective is to fulfill our obligations under our authorizing statute (1) to administer and approve the methods by which a member vote on a conversion proposal is taken, and (2) to promulgate rules governing charter conversions that implement the statutory directive of adequate notice about proposed conversions to the membership.[1] To these congressionally mandated ends, NCUA has promulgated regulations and advocated legislation designed to ensure that a credit union's member-owners have the ability to make an informed choice about their credit union's future. We believe that, to achieve a fair conversion vote by an informed membership, three standards must be met. Credit union officials must faithfully fulfill their fiduciary duty to the credit union's members and closely examine whether a charter conversion is in the members' best interests. Credit union officials must give members full and fair disclosure regarding any conversion plan, providing, for example, an objective analysis of the transaction, regulatory variations, including the implications of thrift lending limits,[2] benefits to

[1] See 12 U.S.C. §1785(b)(2)(C), (G).
[2] See 12 U.S.C. §1467a(m), the qualified thrift lender test.

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management, and importantly, any changes in member voting rights. Finally, members must have a meaningful way to communicate with credit union directors and other members so they may share their views regarding any conversion proposal.

In implementing these policies, NCUA is mindful of Congress's charge that it promulgate rules that are neither more nor less restrictive than those governing other kinds of charter conversions.[3] As such, NCUA, like other regulators, has focused on ensuring that members receive adequate notice and that they understand what they are voting on.

Any motivation by officials to convert in order to realize personal financial gain presents a clear conflict in achieving the standard that a conversion be pursued only if it serves the members' best interests. The statements I, and others within NCUA, have made that question the motives behind credit union conversions are well founded. In fact, banking consultants, including those with which the Coalition for Credit Union Charter Options is associated, have made public statements that contribute to NCUA's concern. For instance, a website promoting credit union conversion, that includes a prominent link to your coalition, contains an article entitled "CEO & Directors: Salary Imbalance is Corrected by Converting to a Bank."[4] This article is found in a newsletter generated by Alan Theriault, who advises credit unions considering conversion to a mutual savings institution charter.

The article first notes that credit union CEOs receive much less cash compensation than bank CEOs, ranging from 20% to 57% less depending on asset size.[5] It also states that, while most credit union directors are unpaid, bank directors earn between $2,500 to over $50,000 annually, in addition to travel and expense allowances.[6] It then follows by stating "[t]he gap in pay can be much wider at individual institutions which utilize stock, or phantom stock compensation programs."[7]

The article continues by identifying additional benefits available only to directors and management after conversion, including a share in a recognition and retention reserve equal to 4% of a stock bank's initial public offering (IPO) which vests over a five year period. The article provides the following analysis:

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[3] 12 U.S.C. §1785(b)(2)(G)(i).
[4] Theriault, Alan D., *CEO & Directors: Salary Imbalance is Corrected by Converting to a Bank*, CONVERTING FROM A CREDIT UNION FAX UPDATE, Sept. 16, 2002, *available at* http://www.cufinancial .com/pdfs/ NL2002.pdf.
[5] Id.
[6] Id.
[7] Id.

> For example, assume a credit union with $50 million in capital converts to a stock bank with an IPO amount of $100 million, directors would share a $2 million grant of stock and management would receive an equal grant. Each member of a five director board would get $400,000 in stock, vested over five years, at the IPO value. The directors would now have the incentive to increase stock value for the benefit of themselves and the member owners that obtained shares in the IPO.[8]

Finally, the article concludes by detailing various other opportunities for a credit union-turned-bank executive to accrue wealth. "[T]he reward for performance could lead to a $10 million plus, ownership stake for a capable CEO. If the conversion is not made during the current tenure, the next CEO in charge may very well realize the value."[9]

Mr. Theriault's article evidences a marketing plan by banking consultants that persuades credit union executives to move towards a mutual savings bank conversion and subsequent stock bank conversion based, at least in part, on personal, pecuniary interests. Given the emphasis by a leading conversion consultant on opportunities for personal financial gain by executives and officials, it is difficult to imagine that their view is not distorted when determining whether a conversion is in the best interests of the membership.

Conversion proponents acknowledge this conflict of interest. A well-known banking expert, Bert Ely, provided insight behind the drive to convert credit unions to savings banks. In an article published by a credit union trade magazine, Mr. Ely was quoted as saying "'[i]t really was a no-brainer. . . You had all this money sitting there without anyone's name on it.'"[10] It was also reported that Mr. Ely, "who is firmly on the pro-conversion side of the debate, would not call greed the primary motivating factor behind the conversions but said it came in a close second."[11]

A review of the past ten years indicates that a credit union conversion to a mutual savings bank is typically followed by a conversion to a stock charter as soon as possible. This trend provides further evidence that, not only does a conflict of interest exist, but directors and managers usually take the next step towards profiting from their decision to convert by subsequently converting to a stock-issuing financial institution. Of the 27 federally-insured credit unions that have converted or merged into a non-credit union institution between 1995 and 2004,

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[9] Id. at 2-3.
[10] David Morrison, *For Years, Consultants and Greed Have Driven Coops in Other Industries to Go Stock-owned; CU Wave May be Just Starting*, CREDIT UNION TIMES, March 17, 2004, at 1
[11] Id. at 51.

20 became a stock bank or merged into an existing stock institution; simply put, nearly three-fourths of these former credit unions stepped away from a mutual form. These numbers suggest the significant likelihood that a converting credit union will convert again from a mutual to a stock institution.

In the spirit of full and fair disclosure to members, credit union officials should inform members that if they vote to convert to a mutual thrift: 1) their voting rights may change; and, 2) the mutual may later convert to a stock institution. Credit union members should know that their voting rights may change from one vote per member to the typical thrift voting method of one vote per $100 on deposit. This disclosure is important, especially if the credit union's directors intend on a second-tier conversion, because members must understand that their right to decide on a subsequent conversion to a stock bank may be limited in comparison to their initial vote to convert the credit union. Under the commonly-used mutual thrift voting method, individuals with greater amounts on deposit will decide whether the mutual becomes stock-owned; this allows insiders and others with large deposits to control a conversion vote that will reap monetary rewards for them as individuals. While NCUA is not the regulator for the second-tier conversion, we believe credit union officials have a responsibility to make these critical disclosures in order to present a full and accurate assessment of the credit union's future.

Investment experts claim "conversions from mutual-to-stock ownership have also provided potential windfall opportunities to individual investors. Because the depositors own the mutual thrift, they are first in line for subscription rights to purchase shares of the newly formed stock company."[12] Unfortunately, it seems that a relatively small percentage of credit union members-turned mutual depositors purchase shares in the new stock institution.[13]

Furthermore, "[o]wnership control of credit union-converts almost always ends up in the hands of a small handful of insiders--directors and officers--after the institution converts to a stock-owned savings bank."[14] This is initially accomplished through stock ownership in an amount up to 14% of the equity of

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[12]SNL Financial's web page discussing mutual thrift conversions at http://www.snl.com/bank/conversions/.

[13] "IGA [Federal Credit Union] had opened in 1975 and served just Peco workers. It, too, was evolving: from a credit union, to a mutual bank owned by its depositors, to a publicly traded company, all in the space of a year. . . . Though IGA executives said the 1999 stock sale was meant to benefit the Peco workers who had built the credit union, he [Richard Balentine] was among only about 5 percent of depositors who chose to buy stock." Mario F. Cattabiani, Jennifer Lin & Craig R. McCoy, *A Fast-moving and Enriching Merger; Fumo's Bank Aimed to Merge Quickly with a Former Credit Union, But Ran Into Regulatory Yellow Lights,* THE PHILADELPHIA INQUIRER, May 16, 2005, at A1.

[14] *Insiders Gain Control Of CUs After Conversion,* THE CREDIT UNION JOURNAL, June 13, 2005, available at http://www.cujournal.com/archive/.

the newly public savings bank and, later, "by control over the employee stock ownership plan and a charitable foundation where a chunk of the newly minted stock is parked."[15] There are several examples of officials of recently converted credit unions who have positioned themselves to control at least 25% of the resulting stock institution's shares.[16]

These trends provide ample support for NCUA's unease. We also note that NCUA is not the first regulator to raise concerns about conflicts of interests within the context of conversions. The Office of Thrift Supervision expressed similar concerns in a 1994 interim final rulemaking by stating in the preamble:

> Given that mutual savings associations currently seeking to convert generally are well-capitalized, the OTS has become increasingly concerned that the association's management may be undertaking conversions for reasons other than the need for capital. Some thrift insiders may be sacrificing the interests of their associations and mutual account holders to acquire significant amounts of conversion stock and other benefits as cheaply as possible in the conversion process. In addition, in some cases the issuance of conversion stock to a MRP [management stock benefit and recognition plans] lessens the opportunity for depositors to obtain conversion stock.[17]

NCUA views the conflicts of interest inherent in credit union conversion deliberations as undeniable. NCUA asks you to join the agency in seeking legislation that would ensure directors approve of conversion plans in the best interests of members and would enable members to make informed decisions about charter options promoted by unbiased directors. The version of the Credit Union Membership Access Act of 1998 initially passed by the House of Representatives included a provision entitled "Assuring Independent Decision Making In Connection With Certain Conversions." It would have prohibited all

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[15] Id.

[16] "[I]n the case of First PacTrust Bancorp., known until January 2000 as Pacific Trust FCU, 11 directors and managers now own 15% of the bank's equity and the ESOP owns 9.9%, totaling approximately 25% of the publicly traded shares--which is considered by the SEC as control of a publicly owned company. In the case of Rainer Pacific Savings Bank, known until 2000 as Rainier Pacific CU, 17 directors and executives own 12% of the equity, the ESOP owns 9.41% and the charitable Rainier Pacific Foundation holds 7.09%--for a controlling 28.5% of the public float. Similar scenarios have occurred in BUCs Federal Savings Bank, formerly BUCs FCU, where insiders own 21.1% of the shares and control the ESOP's 8.9%; Allied First Bank, formerly Allied Pilots FCU, where 10 officers and directors own almost 24% of the stock; Citizens Community Bancorp, once Citizens Community CU, where almost a third of the publicly trade stock is controlled by directors and officers; and Synergy Financial Savings Bank, formerly Synergy FCU, where 12 insiders own half of the public float." Id.

[17] 59 Fed. Reg. 22725, 22729 (May 3, 1994).

directors, committee members and senior management of a credit union, or an institution that converted from a credit union, from receiving any economic benefit with regard to their shares or interests in the converted credit union or any resulting institution, if they served at any time during the 5-year period before the conversion.[18] We believe the enactment of a similar statutory prohibition would assure that only unbiased officials would evaluate whether a conversion plan serves the membership and direct the conversion process, including notices and disclosures, in a manner that serves the interests of the member-owners.

In the absence of a legislative change that addresses the conflicts of interests discussed above, NCUA will do its part to fulfill its statutory obligation to see that votes are fairly conducted and that credit union officials comply with their fiduciary duties to members, provide full and fair disclosures to members, and permit members to participate in the process as the current statute contemplates. We will continue to evaluate how the agency's rules and procedures can better accomplish these goals for credit union members.

Finally, it is important to address the other issues you raise in your letter related to the safety and soundness of the credit union system and to correct the record by providing more complete and accurate information:

- You raise concerns regarding the long-term solvency of credit unions. In 2004, 13.15% of federally insured credit unions (1,183) experienced a net operating loss. Indicative of their small size (average of $12 million), the combined assets for these credit unions represent only 2.3% of NCUSIF insured assets. For comparison, 532 insured banking institutions operated at a loss in 2004 representing 5.9% of those institutions and 0.9% of insured assets. However, the average size of unprofitable insured (profit-motivated) banking institutions is much larger at $170 million. Credit unions, as non-profit organizations, return earnings in excess of capital needs to their members in the form of lower loan rates, lower fees, and higher dividend rates. Considering the fact that the average net worth ratio for unprofitable credit unions is high at 14.1% (and only declined 52 basis points from the operating loss), incurring a loss to return excess retained earnings to members through better rates and adding services is a sound strategy. Further, the increase in the number of credit unions experiencing operating losses is not surprising given the very flat yield curve over the last few years and the conservative (i.e., short-term) stance these credit unions have taken in terms of their investment and lending portfolios.

- You assert that about 40% of credit unions earn less than 40 basis points in return on assets. In 2004, 23.3% of federally insured credit unions (2,099)

[18] 144 CONG. REC. H1871 (daily ed. April 1, 1998).

generated a profit of less than 40 basis points. Indicative of their small size (average of $23.6 million), the combined assets for these credit unions represent only 7.7% of NCUSIF insured assets. These credit unions have a high average net worth ratio of 13.9%, actually increasing their net worth ratios by 11 basis points on average despite the lower profitability levels. There is no evidence to support that these credit unions collectively are engaging in riskier activities due to lower profitability levels, especially given their high capital levels.

- You claim that 10% of credit unions represent 90% of the share insurance fund. As of June 30, 2005, 25.9% of federally insured credit unions hold 90% of federally insured credit union assets. In comparison, the largest 13.3% of insured banking institutions hold 90% of total insured bank assets. Thus, though the credit union industry has become more concentrated, the concentration risk for banks is much higher.

- You attribute negative statements to the Government Accountability Office (GAO) regarding NCUA's supervision of corporate credit unions. GAO's review found corporate credit unions to be in sound operational and financial condition. The final report, *Corporate Credit Unions: Competitive Environment May Stress Financial Condition, Posing Challenges for NCUA Oversight,* provided several recommendations to enhance our supervision efforts.[19] We appreciated GAO's insight and implemented a number of their suggestions. However, it would not be accurate to characterize GAO's findings as an indication that our existing supervision efforts were found to be lacking in ensuring the safety and soundness of the corporate credit union system.

- You state the issue of secondary capital is driving most conversions. Since 1991 credit union assets have grown by 185 percent. Despite this strong level of asset growth, net worth in relation to assets increased by 75% to an historic high of 11% as of December 31, 2004. In terms of prompt corrective action, almost all (98%) of federally insured credit unions are considered well capitalized. Even the fastest growing credit unions have demonstrated the ability to maintain safe and sound capital levels without the need for alternative forms of capital. Consider, for example, the 100 credit unions that have grown the fastest over the last five years (not counting new charters or credit unions that have taken in mergers). These 100 credit unions have on average grown 172% over the last five years, with growth levels ranging from 114% to 655%. They currently enjoy a high average net worth ratio of 10.5%, experiencing on average a decline due to the very strong asset growth of only

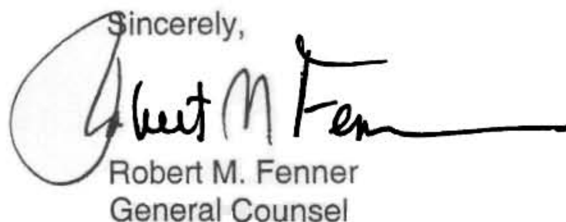
[19] GAO 04-0977, September 10, 2004.

82 basis points over this five year period. In fact, one-third of these credit unions actually had increases to their net worth ratios.

As the GAO report, *Credit Unions – Available Information Indicates No Compelling Need for Secondary Capital* notes, there are key unresolved issues regarding secondary capital, such as whether or not secondary capital instruments would be commercially viable, to whom these instruments could and should be sold (e.g., inside versus outside investors), the effects on the member-owned cooperative structure of credit unions, and any safety and soundness and systemic risk implications posed by this activity.[20] In view of these issues and the fact that the vast majority of insured credit unions maintain extremely strong capital positions notwithstanding a recent prolonged period of rapid share growth, there is a lack of consensus within the credit union system on the need for and appropriate structure of secondary capital instruments.

Thank you for your letter and the opportunity it has provided us to set the record straight concerning the serious conflict of interest that exists in the current conversion process and concerning the financial strength and safety and soundness of the credit union system.

Sincerely,



Robert M. Fenner
General Counsel

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cc: Chairman JoAnn Johnson
William DeSarno, Inspector General
Rep. Michael G. Oxley
Rep. Barney Frank
Rep. Jeb Hensarling
Rep. Patrick McHenry

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[20] GAO 04-849, August 2004.