FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, DC 20429
Division of Supervision

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November 8, 2000

Manager, Dissemination Branch
Information Management and Services Division
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552

10:03

Attention: Docket No. 2000-56
Docket No. 2000-57

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Dear Madam/Sir:

On July 12, 2000, the OTS issued an interim final rule governing repurchases of stock by recently converted savings banks and waivers of dividends by mutual holding companies. On the same date, the OTS also proposed a comprehensive strategy, including revised regulations, governing mutual institutions, mutual holding company reorganizations, and the mutual-to-stock conversion process. The OTS invited comment on both the interim final rule and the proposed rule.

FDIC staff members with expertise in this area reviewed the proposal, and offer the following comments with regard to our respective approaches in regulating an intricate mutual to stock conversion process.

The interim and proposed rules relating to the treatment of stock repurchases within the first year following conversion appear to be an appropriate response to industry practice of converted banks or companies requesting regulatory non-objection to the repurchase of stock soon after conversion. Preamble commentary makes reference to the treatment accorded by other banking regulators. In this regard, the interim final rule essentially parallels the FDIC's section 333.4 (d), limiting converted institutions during the first year after conversion to repurchases of no greater than 5 percent of their outstanding capital stock provided compelling and valid business reasons are established to the satisfaction of the OTS. This would establish similar treatment to our affected institutions.

The proposed rule would also establish several new, worthwhile changes, such as a separate, prior review of business plans and standards relating to charitable foundations. We fully support the proposed new requirement to obtain regulatory non-objection to conversion business plans prior to acceptance of conversion applications. The proposed requirements relating to charitable organizations are generally consistent with FDIC precedent, although the FDIC has not previously required a separate shareholder vote. The proposed changes implementing Gramm-Leach-Bliley Act provisions relating to mutual holding company activities limitations present no issues of concern.

The OTS proposes certain modifications, several of which are intended to enhance the attractiveness of the mutual holding company form of business, that cause a divergence between our respective supervisory approaches to mutual-to-stock conversions. The divergence from FDIC policies and precedents include:

- Preferences granted the mutual holding company structure,
- Accounting for waived dividends in subsequent distributions of value,
- Depositor priority in any oversubscribed offering,
- Absence of guidance relating to merger/conversions,
- Acquisition of converted institutions within three years of conversion, and
- Expansion of management stock benefit plans.

In addition, we offer comments on special capital distributions. Each of these issues is discussed in more detail below, and our staff would appreciate a meeting to deliberate on these items as you consider comments received on your proposal.

Structure – Mutual Holding Company Preference

In preamble commentary, OTS encourages consideration of the mutual holding company (MHC) alternative (with an implied minority stock issuance). We share the OTS's belief that without a clear need for additional capital and a realistic opportunity for prudently deploying its capital to earn a competitive return on shareholder equity over the longer term, mutual institutions should consider other alternatives short of full conversion. As noted in the preamble commentary, mutual institutions may choose from a number of alternative means to augment capital short of conversion, including mutual capital certificates, subordinated debt, trust preferred securities, and real estate investment trusts.

We recognize that one popular alternative is to convert to a MHC structure with only a minority issuance of stock, thereby reducing capital funds raised. However, beyond the reality that certain institutions may be unable to effect viable partial-conversion transactions, the FDIC favors a neutral stance on the full- or partial-conversion question. Decisions relating to ownership form and business structure are circumstance-specific and are best made by mutual institutions' trustees and management. We do not believe that any structure is so beneficial as to require regulatory preference, and none isolate institutions from the issues and complexities presented by market forces. Like fully-converted institutions, partially-converted institutions likely have relatively higher capital levels, earn lower returns on equity, face pressure from shareholders/depositors, and may require additional management expertise to execute the conversion-related business plan.

Dividend Waivers

The interim rule governing holding company dividend waivers represents a significant departure from how the FDIC has historically treated waived dividends. By not requiring waived dividends to accrue solely to the benefit of the mutual constituency, the rule confers an unnecessary premium to shares held by the minority and discounts depositor rights, creating a difference relative to long-standing precedents established by the FDIC Board of Directors.

We understand there may well be reasons for waiving dividends, taxation considerations chiefly among them; however, the FDIC has long held the position that waived dividends not be available for any distribution to the minority shareholders. Our position has a simple premise: minority shareholders, having already received their dividend, have no right to maintain their ownership percentage unless they, like the MHC, reinvest their dividends in the subsidiary depository institution.

Congress authorized MHCs, in parity with their bank holding company counterparts, to own multiple subsidiaries beyond the converted savings institution thereby expanding their business opportunities and benefiting from the resultant diversification. Because of these many benefits, the market has readily accepted the MHC structure. The FDIC has for some time granted non-objection to conversions based on an understanding that any dividends waived by the MHC would not accrue for the benefit of minority shareholders already receiving a cash dividend. The very reasons MHCs presented as the bases for requesting dividend waivers – that dividends are saved from corporate taxation and that the capital is left at the subsidiary savings institution to be deployed more efficiently – are soundly premised in the economic well-being of the MHC (and thus its constituency). Given the many conversions readily undertaken with dividend waiver restrictions fully disclosed in offering materials, we find it difficult to identify compelling arguments which necessitate trustees foregoing the MHC's economic right to waived dividends. Indeed, reinvestment of dividends by investors is an established market principle; such dividend reinvestment plans are commonly used by many investors, but have not been used in the mutual to stock conversion arena historically. Perhaps this alternative could be studied.

We also fully understand that our policy position impacts the proportional ownership of the MHC and the minority investors. We believe the proportional ownership changes are economically just. The MHC (majority shareholder) essentially reinvests its dividends without a concomitant increase in its shareholdings, while the minority receives cash payments (which may or may not be reinvested). Those investors who receive a cash dividend should fully understand that those investors who "waive" (reinvest) their dividends have an additional claim on ownership of the company. That constant proportional ownership of minority shareholders must be maintained is simply not a market reality. Ownership stakes change regularly – shares are bought and sold, options are granted, and/or additional shares may even be issued to the public.

Such waivers raise conflicts of interest issues and require great care in trustees' exercise of fiduciary duty. The conflict of interest is clear where the directors/trustees of the MHC, who requests dividend waivers, also often times hold a significant minority interest of the subsidiary depository institutions and, if so, will personally benefit from the waivers to the detriment of their respective depositor constituency.

Even absent the potential benefit received by trustees who are also minority shareholders, the minority ownership stake, as a whole, cannot be proportionally maintained at the unquantified expense of the mutual constituency without raising issues of fiduciary duty. This is true in the case of both converted bank subsidiaries of a MHC and for other independent investments by a MHC. In a subsequent, "second step" conversion to full stock form, MHC investments would be separately and independently valued, and the MHC would retain first priority to that value. We find it difficult to reconcile the proper exercise of trustees' fiduciary duty against overtly reassigning value to minority shareholders, value so clearly due the MHC. Rather than a safety and soundness issue, as suggested in the proposed rule, the issue appears to be one of fiduciary duty. In the FDIC's case history, fiduciary duty of trustees', when granting a dividend waiver, has been considered fulfilled only with proper accounting and allocation of the waived dividends.

Depositor Priority

The proposed rule governing conversion from mutual to stock form retains a provision allowing converting thrifts to allocate conversion stock to tax-qualified employee stock ownership plans (ESOP), up to a maximum of 10 percent, when the conversion stock valuation maximum is increased. Under this provision, a tax-qualified ESOP essentially enjoys first priority, often at a time when a stock offering is over-subscribed and depositors are most interested in exercising their subscription rights. We recognize that depositors in federal mutual savings banks otherwise receive first-priority subscription rights. Because the 50 states vary considerably in allocating subscription rights, the FDIC's regulations provide that eligible depositors should have higher subscription rights than ESOPs. The FDIC commonly disallows subscription priorities allocating ESOP subscription rights higher than those accorded depositors, regardless of the resulting valuation. The FDIC's Board of Directors has reaffirmed this stance on a number of occasions under the premise that depositors are viewed as the best proxy representing the mutual constituency and therefore receive first priority subscription rights.

Merger/Conversion

The proposed rule governing conversions from mutual to stock form is generally silent on the issue of merger/conversion, although proposed § 563b.20 states: "When you convert to stock form, you may acquire for cash or stock another insured depository institution that is already in the stock form of ownership." If this section contemplates merger/conversion, it does not delineate what standards the OTS will use to evaluate such proposals.

The FDIC has considered several proposals wherein smaller institutions would convert and simultaneously merge with and into stock institutions. The FDIC Board of Directors has approved merger/conversion transactions when the value of the converting institution is determined in a fair manner and that value is delivered to the rightful recipients, as determined by the directors/trustees of the institution in the proper exercise of their fiduciary responsibilities.

We are aware of at least one instance where the OTS has approved a merger/conversion. We ask that you consider clarifying the standards applicable to merger/conversion transactions.

Acquisition Within Three Years of Conversion

We believe a three-year prohibition on mergers involving converted institutions provides too little flexibility in comparison to the OTS's present practice of granting waivers on a case-by-case basis. Those institutions that convert for legitimate business reasons and satisfy the other necessary conversion standards should be free, after competing in the market for a reasonable time, to pursue acquisition partners consistent with a proper determination by directors/trustees. Since such filings are subject to the Bank Merger Act, any substantive concern relating to fiduciary duty can be effectively addressed in the consideration of the circumstances related to a specific merger application filing.

Expansion of Management Stock Benefit Plans

The proposal governing conversion transactions expands management stock benefit plans to an amount equal to the maximum allowed for a MHC; that is, even if the minority offering is issued at less than 49 percent, insiders can receive benefits as if minority stockholders held 49 percent of the stock. The FDIC has expressed concerns relating to management compensation in the context of mutual to stock conversion. It is an inherent conflict of interest, and in certain situations it could be considered a breach of duty, for management to propose to convert a mutual institution to stock form when, as part of the proposed conversion, management would receive benefits unreasonable in relation to those received by depositors or other identified interests.

We believe the proposed change creates the impression that insider enrichment may remain a primary decision factor in conversions. In the example cited in the preamble, while the minority stock issuance totals 20 percent of the stock issued, insiders potentially receive, through benefit plans (management recognition plans, stock option plans, and employee stock ownership plans), a disproportionate share of the total stock issued. We would encourage a structure that appropriately aligns the interests of management with those of the shareholders without providing a disproportionate advantage to one particular interest.

Special Capital Distributions

In the preamble to the proposed rule governing conversions, the OTS seeks comment on the issue of "special capital distributions." Given the delicate balance between having too much capital in times of economic prosperity and not enough capital in less fortunate times, we believe in a cautious approach to returning any portion of a mutual institution's "excess" capital to its community. Just as stock repurchases require review of business plans and judgements on an institution's efforts to otherwise deploy its capital, distributions beyond nominal bonuses based on deposit volume should receive a high degree of scrutiny.

In determining the appropriateness of a bank's request to retire capital, the FDIC considers several factors, including its financial history and condition, the adequacy of its remaining capital structure, its future earnings prospects, the general fitness of its management, and the convenience and needs of the community to be served. In the context of merger/conversions, the FDIC has allowed cash payments to depositors; however, in every case, the institutions' resultant capital structures, earnings prospects, and management capabilities improved as a result of the transactions.

While not actually in the context of special capital distributions as contemplated in the OTS's request for comments, the practice of returning capital (tax-free) to investors subsequent to an institution's conversion raises special concerns. Preamble commentary indicates that the OTS will view a proposed return of capital as a material deviation from the conversion business plan, and that such returns will require prior written approval of the applicable OTS regional director. We agree that tax-free returns of capital soon after conversion undermines the mutual-to-stock conversion process and brings into question the soundness of business planning, the adequacy of valuation, the fairness of disclosure. In approving any proposed return of capital, regulators should fully assess any proposed return of capital against the elements of fairness and good faith afforded to the various stakeholders of the mutual institution, particularly depositors.

We trust you will find our observations on the interim final rule and the proposed rule beneficial. If you or other OTS staff members wish to further discuss any of the above issues, please contact Associate Director John M. Lane at (202) 898-6771.

Sincerely,

Michael J. Zamorski

Michael J. Zamorski
Acting Director

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