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Statement of

Scott M. Polakoff, Deputy Director
Office of Thrift Supervision

concerning

The Credit Union Charter Choice Act, H.R. 3206

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

House Financial Services Committee

May 11, 2006

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I. Introduction

Good morning, Mr. Chairman, Ranking Member Sanders, and members of the Subcommittee. Thank you for the opportunity to testify on the Credit Union Charter Choice Act, H.R. 3206, sponsored by Representatives McHenry and Gillmor, among others, and the role of the Office of Thrift Supervision (OTS) when a credit union or other entity seeks a savings association charter.

Charter choice is a fundamental precept at OTS. Since the agency was established in 1989, many institutions have both left and entered the thrift charter. These so-called "charter flips" are a normal course of business at OTS and throughout the banking industry. In our view, it is the role of the regulator to minimize regulatory obstacles, reduce burden and facilitate legitimate business decisions regarding charter choice made by the institutions we regulate.

While I cannot represent the views of the other federal banking agencies (FBAs) regarding the issue of charter choice, I can tell you that all of the FBAs handle the charter flip conversion process similarly. That is, each requires an application to obtain a charter within their jurisdiction, but not to leave their jurisdiction and oversight. While an agency may pass on supervisory and regulatory information to a new regulator, there is generally not a requirement that an institution obtain permission from one of the FBAs to leave its jurisdiction, except where an institution has pending enforcement or similar issues or is in potentially troubled condition.

In my testimony today, I have been asked to describe for you the charter conversion process at OTS, as well as the mutual-to-stock and mutual holding company (MHC) conversion processes in place at OTS. I will also address issues relating to membership rights of mutual account holders, or members, of a mutual savings association, and benefits to management insiders when a mutual savings

association converts to a stock institution or into a MHC structure. Finally, I will conclude with some general observations about H.R. 3206 in light of the discussion of the various OTS conversion processes and comparing these to the requirements of the proposed legislation. But first, I will highlight our general understanding of the provisions of the bill.

II. Summary of H.R. 3206, the "Credit Union Charter Choice Act"

The Credit Union Charter Choice Act is designed to clarify the communications between credit unions and their members. Specifically, the legislation requires that notifications to members of a credit union regarding a proposed conversion should include the following:

- the date that the membership vote will be taken and the date by which ballots must be received by the inspector of elections;
- a brief statement of why the directors of the converting credit union are considering the conversion and the board's recommendation to the members; and
- a brief statement of the material effects of the conversion on the credit union, as converted, and the members, including any differences in powers between a credit union and a savings association.

The bill also clarifies that a credit union may not be required to include in a conversion notice any information or statements that:

- are speculative with respect to the future operations, governance, or form of organization of the institution;
- are inaccurate with respect to a proposed conversion;
- conflict with regulations of other regulators with regard to the subsequent conversion of the institution from mutual to stock form;
- distort the impact of conversion on the members of the credit union; or
- are attributable to the National Credit Union Administration (NCUA) or state the NCUA's position on conversions.

Generally, the bill streamlines the review and approval process conducted by the NCUA regarding conversion materials submitted by converting credit unions to the NCUA. In addition, the legislation requires a credit union's member vote on a conversion to be conducted by secret ballot, with an independent inspector of elections appointed by the credit union to receive and tally the votes. The bill effectively denies the NCUA any further review or approval authority over

the conversion process, absent fraud or reckless disregard for fairness during the voting process that affects the vote outcome.

III. OTS and the Thrift Industry: A Legacy of Charter Choice

OTS oversees an industry and charter that is primarily engaged in retail banking; or, more precisely, retail community banking. The savings association charter is a vital and growing choice in the financial services world, and an important resource for economic growth in this country. The industry is rapidly growing, with total assets up 12.0 percent in 2005 from the prior year to a record $1.46 trillion. In the past five years, industry assets grew 57.7 percent, representing a robust average annual growth rate of 9.5 percent.

Earnings were also strong last year, and have been strong for the last five years. For 2005, earnings were up 17.6 percent from 2004, and the industry earnings more than doubled the last five years, climbing from $8.0 billion in 2000 to a record $16.4 billion in 2005.

Throughout the history of the OTS, there have been many institutions that have left the thrift charter, and many that have opted for the thrift charter as the choice for conducting their ongoing business operations. From 2000 to 2005, there were 90 institutions that converted from the thrift charter to another type of depository institution charter, and 51 institutions that converted to the thrift charter from another type of depository institution charter. Of the 51 institutions opting for the thrift charter, 9 were credit unions and the rest were banks. Clearly, charter choice is a fundamental aspect of the U.S. banking system.

As the retail community banking sector grows, the savings association charter is well positioned to provide a structural and regulatory alternative both for established financial services businesses and for new entrants that are working to grow market share in this area. The savings association charter is remarkably flexible in adapting to the many products and structures present in today's financial services marketplace. It is deployed in neighborhoods all across America, and is also used by leading nationwide lenders, by investment banks offering a full array of financial services, and by global conglomerated involved in a wide array of diverse businesses. These organizations have all come to the savings association charter at different times and for reasons as diverse as their underlying businesses and the markets they serve.

At the same time, there are numerous institutions that seek to conduct their business operations in a different charter form, and OTS supports the ability of any

institution to gravitate to the charter that best serves its business needs and interests.

As long as applicants meet all of the necessary regulatory requirements to create or convert to a savings association, or to opt for another charter type, we strongly support such a choice, and support any legislation that promotes such freedom of choice.

IV. The OTS Charter Conversion Process

Conversions of banks or credit unions to become OTS chartered institutions are generally subject to the same standards for approval as applications for permission to organize a new, or de novo, savings institution.

In summary, OTS regulations authorize credit unions to convert directly to federal mutual savings associations. The institution must have its deposits insured by the FDIC upon completion of the charter conversion and comply with all applicable federal or state laws and OTS policies, and obtain all required regulatory and member approvals.

In addition, the Home Owners Loan Act (HOLA) and OTS regulations set forth standards that OTS must consider when granting a federal charter. Because a credit union conversion requires a new federal charter, OTS must consider these standards. The HOLA states that OTS may grant a charter only if all of the following criteria are satisfied:

- the organizers are persons of good character and responsibility;
- a necessity exists for the savings association in the community to be served;
- there is a reasonable probability of the savings association's usefulness and success; and
- the savings association can be established without undue injury to other local thrift and home-financing institutions.

In addition, OTS regulations provide that OTS must consider whether the savings association will perform a role of providing credit for housing consistent with the safe and sound operation of a federal savings association.

Furthermore, OTS Community Reinvestment Act regulations provide that an applicant for a federal thrift charter must submit with its application a description of how it will meet its CRA objectives. OTS must take the CRA

description into account when considering the application, and may deny or condition the application on CRA grounds.

Applications by credit unions to convert to federal savings associations are also subject to publication and public comment requirements. In addition, OTS is required to verify, under statutes and regulations applicable to credit unions, the member vote concerning conversions of credit unions to federal mutual savings associations.

Membership Rights

An issue often raised in conversions of credit unions to federal mutual savings associations is the rights of credit union members relative to those of federal mutual associations. Certain parties have advanced various reasons why they believe credit union members' rights are compromised when a credit union converts to a federal mutual savings bank.

Much has been made of the fact that credit union voting is conducted on a one vote per member basis, while the federal mutual charter provides for one vote per $100 on deposit, with the association being able to set, in its charter, the maximum number of votes per member at any number from one to one thousand. In our view, this type of voting provision, while different, is at least as equitable as the one member-one vote rule, since it provides greater voting rights, up to a limit, to members that have made a greater contribution to the institution. We believe it is appropriate for an institution to have the flexibility to provide for voting rights based on the extent of the depositors' relationship with the institution.

It is important to note that even though some depositors may have a greater number of votes than others, even in a relatively small institution no accountholder with the maximum number of votes could have any appreciable amount of control of an institution. The smallest credit union to convert to a federal mutual association had assets of approximately $8 million. Even assuming deposits with voting rights totaling $7 million, and a depositor with $100,000 on deposit having 1000 votes, the maximum percentage of votes of a depositor/member would be less than 2 percent of the voting rights of the institution. Only three of the credit unions that converted to a federal charter had assets of less than $20 million. OTS has not reviewed a credit union conversion in which a depositor could have any control of the vote.

Another issue that has been raised is the fact that members of federal mutual associations may, in most matters (excluding mutual-to-stock conversions

and mutual holding company reorganizations), vote by proxy, while credit union members vote by mail ballot. We do not find this to be a meaningful distinction. Members of mutual associations, through proxies, may specify exactly the way they wish to vote. The fact that depositors also have the flexibility to grant management discretionary authority with respect to their vote does not make the voting process less meaningful. While federal mutual associations are able to use running proxies, members may revoke those proxies or use new proxies. The membership voting interest of mutual savings associations is no less meaningful simply because members may use proxies.

The economic nature of membership interests in mutual associations and credit unions is quite similar. The moment a person becomes a depositor/member of either type of entity, the person has the same rights as other members to participate in dividends, or any liquidation of the entity. The moment the person ceases to be a member, they have no continuing interest in the institution. Membership interests in either entity cannot be transferred. Members of either entity cannot compel management to declare dividends. In addition, although liquidations of either type of entity are extremely rare, it is worthwhile to note that liquidation rights in both entities are similar, with depositors sharing in any equity remaining after a voluntary liquidation in proportion to the amount of their deposits. This is a practice consistent with providing greater voting rights to members with a greater deposit investment in an institution.

V. The OTS Process for Mutual-to-Stock and MHC Conversions

The HOLA permits mutual savings associations to convert to the stock form of organization. The statute also permits savings associations to reorganize into MHC form, and to conduct a minority stock issuance of less than 50 percent of the institution's stock. Such transactions are subject to significant regulatory and disclosure requirements.

Since the conversion program began in 1972, mutual-to-stock conversions and minority stock issuances have raised over $35 billion in new capital for the industry. These transactions have enabled savings associations to raise additional capital in a short period of time, rather than raise additional capital slowly, through earnings. In addition, the conversion process enables converted thrift institutions to attract top management by the use of stock benefit plans that formerly were only available to commercial banks and other stock chartered entities.

Today's regulatory system is a result of decades of experience and is designed to produce a fair result to all parties -- depositors, the community at large, new stockholders, and others.

It is important to point out that the mutual to stock conversion process is designed to protect the interests of the institution's mutual accountholders. Conversions and MHC reorganizations must be approved by an association's accountholders, by a majority of the institution's eligible votes. The accountholders are provided detailed, comprehensive disclosures regarding the transaction. Significantly, accountholders are provided priority subscription rights in the conversion stock offering. Furthermore, the converting association establishes a liquidation account in the conversion, which reflects the value of the institution immediately prior to the conversion.

Every conversion begins with an independent appraisal of the mutual institution. That appraisal determines a fair value for the institution as a converted entity. The appraiser presents the results of its analysis to the board of directors of the institution, who vote on the valuation and submit it as part of their application to convert.

Individual members (or depositors) of a mutual thrift institution that determines to convert, are given first priority rights, as noted above, to subscribe for stock based on having a deposit account at the institution at least one year prior to the board of directors vote on a plan of conversion. After the subscription orders of the members are satisfied, a tax-qualified employee stock benefit plan is permitted to purchase shares on behalf of the employees of the institution. The next priority is for depositors who had deposits at the institution fifteen months later than the first priority depositors. Next, any other depositors/members of the mutual thrift who had not been included in earlier categories are given the opportunity to subscribe for shares, i.e., after the subscriptions of earlier subscribers have been satisfied and shares remain. Finally, a community offering may be conducted at the same time as the subscription offering, or later, with any remaining shares sold to natural persons residing in the local community.

It is important to note that management may participate in an offering if they are also depositors, or later as members of the community, and that management purchases are limited by OTS regulations. In addition, management may also participate in stock benefit plans, but only if the stockholders of the newly converted entity passed such plans at least six months following a conversion. OTS regulations strictly limit the amount of shares permitted for

employee stock benefit plans, to assure that the reason for the conversion is not simply to provide shareholder benefits to management.

A critical aspect of the conversion process is preparation of a business plan that shows how the institution intends to deploy the proceeds from the offering during the three years after the conversion.

OTS considers its conversion program to be a tremendous success. While we are strong supporters of mutuality, a mutual-to-stock conversion is the right business strategy for some institutions. For those that choose to convert, OTS' conversion program has been a win-win proposition for all parties.

Mutual institutions that have undertaken the conversion process have been able to raise substantial sums of new capital to grow their businesses. In addition, as part of that process they have been able to compete with other stock institutions by offering management stock benefits to attract top quality managers. By encouraging the use of tax-qualified employee stock ownership plans, OTS has seen the employees who work at the institution be able to participate in the stock offering and become owners of their company. Communities have benefited from conversion transactions, because converted institutions have grown, opening new offices and providing additional services in their communities. Finally, the regulatory system has benefited from the strengthened balance sheets of the institutions we regulate.

Limitations on Management Benefits

As noted above, management benefits are limited in a mutual-to-stock conversion or minority stock offering. Most importantly, before a conversion or MHC stock offering occurs, the members of the institution must approve the transaction. Full disclosure is provided regarding all aspects of the transaction, including management benefits. If the membership objects to management benefits, they may vote against the transaction.

Most managers are also depositors of the institution, and when they purchase stock in the institution, they purchase subject to the same terms that are applicable to other members. All purchases, including those by management, are subject to maximum limits so that no party acquires control in the conversion. In addition, purchases by all managers are subject to an aggregate limit. In rare cases where a manager is not a depositor, the manager's purchase rights are subordinated to those of the members.

Converting savings associations also establish employee stock ownership plans in mutual-to-stock conversions. These are tax qualified employee benefit plans, and are subject to requirements regarding distribution of stock under the plans. Congress has encouraged the use of these plans, and we believe they are no less appropriate for newly converted stock associations than they are for any other type of entity. As I noted earlier, these transactions are subject to member votes, so that if members object to the transaction, they may vote it down.

The institution may also establish management recognition and stock benefit plans after the conversion. OTS regulations provide that these may not be established until at least six months after the conversion. These plans are subject to a separate shareholder vote.

OTS believes that it would be inappropriate to prohibit institutions from establishing these plans after a conversion or minority stock offering. These institutions compete on the same basis as other stock entities, and these benefit plans enable management to retain and attract qualified management in the same manner as other stock entities.

VI. Observations on H.R. 3206 in Light of the OTS Experience

OTS supports all efforts to ensure effective communications between an institution considering a charter conversion and its members. A charter conversion is an important business decision for any institution, and membership input is critical both to inform management regarding member support for a proposed conversion as well as to ensure members will continue to support the institution after a conversion. In our view, H.R. 3206 sets forth a clear set of guidelines that clarify appropriate standards of conduct in communications between an institution and its members. Fundamentally, sound communications assist in the formulation of sound decisions regarding the members rights to exercise their freedom of charter choice.

H.R. 3206 is consistent with existing OTS information requirements and standards of conduct for member communications in connection with mutual-to-stock and MHC conversions. Generally, OTS rules incorporate by reference the disclosure requirements of the federal securities laws. The rules require a meaningful disclosure of all relevant information in connection with a conversion, including the disclosure of potential risk factors and future business plans of an institution. The rules also make clear that disclosures must be clear, accurate, balanced, and not so forward-looking as to be speculative in nature. Again, the

bottom line is that all disclosures must be meaningful. We believe this is a good standard to follow.

For example, requiring detailed disclosures on potential future business plans that may or may not happen serves no meaningful purpose. While it is certainly appropriate to highlight the possibility of future transactions, requiring detailed information on the downsides of such a future transaction and barring discussion of the upside is, in our view, not meaningful and may be best characterized as misleading to the members of an institution. Such disclosures are barred by OTS rules.

Freedom of charter choice only has meaning if members are able to exercise an informed choice, which requires sound and reliable information to be provided to members in the context of a proposed charter conversion. It is critical to find the right balance to ensure that disclosures are both meaningful and useful to institution members.

VII. Conclusion

OTS believes in the fundamental precept of charter choice and supports the efforts of financial services providers to be organized under the charter that best supports their business plan and operating strategy. It is important for all regulators to uphold the basic rights of freedom of choice. Regulatory barriers that do not protect consumers and/or institutions, but rather that serve as regulatory obstacles should be eliminated. The integrity of our financial services system requires this.

I want to thank you, Mr. Chairman, Representatives McHenry and Gillmor, and others who have shown leadership on this issue. We look forward to working with the Subcommittee as you continue to work through this important issue.