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Changing Ownership of Mutual Savings and Loan Associations: An Evaluation. FOD-77-10; B-114827. May 26, 1977. 22 pp. + appendix.

Report to Sen. William Proxmire, Chairman, Senate Committee on Banking, Housing and Urban Affairs; by Elmer S. Staats, Comptroller General.

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In 1974, the Federal Home Loan Bank Board was permitted to approve 41 savings and loan association conversions from a mutual to stock form of ownership. The sale-of-stock method of conversion has provided opportunities for an association to raise additional capital, expand operations, and increase earnings. In eight associations reviewed by GAO, the primary reason given for converting from a mutual to a stock association was the need to obtain additional equity capital to meet or increase net worth requirements. Findings/Conclusions: The Board needs to increase its monitoring of associations to determine whether they are complying with conversion regulations and whether additional regulations or revisions to existing regulations are required to assure equitable conversions. In the review, it was noted that: (1) members of management and their associates significantly increased their holdings through stock transfer soon after conversion; (2) management and its associates at some associations increased their savings account balances before the eligibility record date of conversion; and (3) Board regulations on rights under subsequent stock issues, stock transfer agents, and acquisitions of converted associations need revision because they conflict with the objective of conversion--broad participation with little or no benefit to insiders. Additional time is needed to monitor the conversion process, refine regulations, and assess further the impact of conversions on the savings and loan industry. Recommendations: The Federal Home Loan Bank Board should: develop and implement monitoring procedures so that existing regulations are adhered to; identify and seek legislative changes in the law relating to penalties and enforcement authority; and strengthen existing regulations. (RRS)

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REPORT TO THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

BY THE COMPTROLLER GENERAL
OF THE UNITED STATES



Changing Ownership Of Mutual Savings And Loan Associations--An Evaluation

Federal Home Loan Bank Board

GAO reviewed 8 of the 22 associations that have converted in the last 2 years from mutual to stock form of ownership to raise additional equity capital. GAO found that:

- The Board did not adequately monitor conversion activities.
- The Board regulations regarding rights under subsequent stock issues, stock transfer agents, and acquisitions of newly converted associations conflict with conversion objectives.
- It was not possible to assess the accuracy and fairness of appraisal valuations.
- There are alternatives to the sale-of-stock method for raising additional equity capital.

GAO believes the Congress should limit the number of conversions through September 30, 1979. The time extension is needed to determine whether conversions are desirable and can be achieved on an equitable basis.



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

B-114827

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

Dear Mr. Chairman:

In response to your request and later discussions with your office, we reviewed the results of the Federal Home Loan Bank Board's experimental test of converting savings and loan associations from mutual to stock form of ownership. The report discusses Board regulations and compliance, post conversion results, stock appraisals, and alternative methods of handling net worth problems facing the savings and loan industry today.

We will furnish to you separately our legal opinion as to whether 12 U.S.C. 1725(j) authorizes the Board to approve conversions of Federal mutual to Federal stock savings and loan associations after June 30, 1976.

This report contains recommendations to the Chairman of the Federal Home Loan Bank Board which are set forth on page 10. As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report. We will be in touch with your office in the near future to arrange for release of the report so that the requirements of section 236 can be set in motion.

The report has been discussed with Board officials and their comments incorporated where appropriate.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "James B. Stacks".

Comptroller General
of the United States

C o n t e n t s

	<u>Page</u>
DIGEST	i
CHAPTER	
1 INTRODUCTION	1
The conversion process	1
Scope of review	2
2 CONVERSIONS: A LIMITED ANALYSIS	3
Conversion regulations	3
Better monitoring of Board regulations needed	4
Board regulations need strengthening	6
Conclusions	9
Recommendations	10
Agency comments	10
3 STOCK APPRAISALS--HOW GOOD ARE THEY?	11
Board regulations and procedures	11
Appraisal methods	12
Qualifications and independence of appraisers	16
Our evaluation of appraisals	17
Conclusions	18
4 ALTERNATIVE METHODS OF INCREASING NET WORTH	19
Distribution of free stock	19
Sale of stock and establishment of a public trust fund	20
Sale of subordinated debentures	21
Conclusions	22
APPENDIX	
I Letter dated July 13, 1976, from the Chairman, Committee on Banking, Housing and Urban Affairs	23

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

CHANGING OWNERSHIP OF MUTUAL
SAVINGS AND LOAN ASSOCIATIONS--
AN EVALUATION
Federal Home Loan Bank Board

D I G E S T

Public Law 93-495, approved October 28, 1974, permitted the Federal Home Loan Bank Board to approve 41 savings and loan association conversions from mutual to stock form of ownership and to complete the 8 applications already received. The limit was set so that the Congress could assess, on an experimental basis, whether conversions were consistent with the public interest.

Through May 1, 1977, the Board had received and accepted for filing 73 applications and plans for conversions from the mutual to stock form of ownerships, where stockholders replace depositors as owners. Twenty-five were approved, and 48 were either incomplete or waiting Board review. Of the approved applications, 22 have converted and 3 are in process. GAO reviewed 8 of the 22 associations that have converted.

To continue expansion, savings and loan associations are compelled to raise additional equity capital because of net worth requirements imposed by Board regulations. These regulations require an insured association to maintain a net worth equal to or greater than a specified percentage of its savings deposits, plus 20 percent of certain association assets, such as delinquent loans and real estate owned as a result of foreclosures.

The sale-of-stock method of conversion has provided opportunities for an association to raise additional capital, expand operations, and increase earnings. In the eight associations GAO reviewed, the primary reason given for converting from a mutual to stock association is the need to obtain additional equity capital to meet

or increase net worth requirements. This need occurred during a period when associations were experiencing a rapid savings growth. (See p. 19.)

The Board issued regulations for associations to follow in initiating and carrying out a conversion. GAO's review of these regulations and the eight conversions showed that the Board needs to increase its monitoring of associations to determine whether (1) they are complying with the conversion regulations and (2) additional regulations or revisions to the existing regulations are required to assure equitable conversions.

Specifically, GAO noted that:

- Members of management and their associates significantly increased their holdings through stock transfers soon after conversion. At one association, for example, management acquired 21,592 shares that were transferred on the stock issuance date. These acquisitions increased management holdings from 5 to 31 percent. (See p. 4.)
- Management and its associates at some associations increased their savings account balances before the eligibility record date of conversion. This resulted in members of management obtaining subscription rights to purchase additional shares. (See p. 5.)
- The Board regulations on rights under subsequent stock issues, stock transfer agents, and acquisitions of converted associations need revision because they conflict with the objective of conversion--broad participation with little or no benefits to insiders. (See p. 6.)

GAO's review showed that the independent appraiser is responsible for the specific valuation of the converting association.

Persons and firms independent of the converting association who were experienced in the area of finance, economic conditions, and appraisal of corporate securities prepared the appraisals. The appraisals were made in a manner consistent with Board regulations and guidelines. However, because of the nature of the valuation process, GAO could not assess the accuracy and fairness of the appraisals. (See p. 11.)

The sale-of-stock method is one way for an association to obtain additional net worth. There are other methods for achieving this result. However, if any alternative to conversion other than by sale of stock is to be used, Board regulations would have to be changed. Also, because some of these alternatives may not be attractive to potential converting associations, the methods may have to be directed by the Congress. (See p. 22.)

Additional time is needed to monitor the conversion process, refine regulations, and assess further the impact of conversions on the savings and loan industry. Therefore, GAO recommends that the Congress limit the number of conversions through September 30, 1979. This limit should be similar to that expressed in Public Law 93-495. During this period, the Chairman of the Federal Home Loan Bank Board should:

- Develop and implement monitoring procedures so that existing regulations are adhered to.
- Identify and seek legislative approval for needed changes in the law relating to penalties and enforcement authority to assure more equitable conversions.
- Strengthen existing regulations on rights under subsequent stock issues, stock transfer agents, and acquisitions by holding companies and others of newly converted associations. (See p. 10.)

The above matters were discussed with Board officials and they generally agreed with GAO's conclusions and recommendations.

CHAPTER 1

INTRODUCTION

The Chairman, Committee on Banking, Housing and Urban Affairs, requested that we review certain aspects of the conversions of savings and loan associations from mutual to stock form. The Chairman asked questions concerning Federal Home Loan Bank Board regulations, stock appraisals, effects of ownership transfer, and conversion alternatives. (See app. I.)

The basis for the Committee request was the Board's June 1976 interim report on its study of 10 conversions. The Committee stated the Board's interim report lacked substantial evidence that the conversion process is effective and satisfactory. The most important issue is the desirability of placing these mutual business enterprises into private hands without enriching insiders at the expense of savers who contributed to the association's equity.

Public Law 93-495, approved October 28, 1974, permitted the Board to approve 41 savings and loan association conversions from mutual to stock form of ownership and to complete the 8 applications already received. The limit was set so that the Congress could assess, on an experimental basis, whether conversions were consistent with the public interest. The limit expired on June 30, 1976.

As of May 1, 1977, the Board had received and accepted for filing 73 conversion applications, including the plans of conversion--25 of these were approved and 48 were either incomplete or waiting Board review. Of the approved applications, 22 mutual savings and loan associations have completed conversion to stock and 3 are in process.

THE CONVERSION PROCESS

The conversion process begins by developing 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, where the application is checked for completeness. If the Board approves the conversion application, notice of approval is published in the "Federal Register." The association then issues proxy statements and the Board requires a 30-day period for legal protests.

A special meeting is called to obtain the approval of association members to convert. If approved, a preliminary stock offering circular, approved by the Board, is issued to eligible subscribers. A final offering circular is issued to the public or the management syndicate, after the subscription period. The process is completed when the association issues the stock and the Board or State authorities issue a stock charter.

For the first seven associations in our review, the average conversion processing time was 22 months. Delays were caused by regulation and procedure changes after the associations filed their applications to convert. The Board, with increased efficiency and improved procedures, reduced the processing time to about 6 months for the eighth association.

SCOPE OF REVIEW

We made our review at the Federal Home Loan Bank Board headquarters, Washington, D.C., and at savings and loan associations in Florida, Maryland, New Mexico, Ohio, and Texas. The Chairman requested that we review 10 associations. However, one of these associations had not completed conversion at the time of our review and a second converted under previously issued regulations. These two associations were excluded from our review.

We reviewed Board regulations, guidelines records, and reports and interviewed Board officials. We examined associations' records and interviewed management. We also interviewed officials in related businesses in reference to their roles in and views on savings and loan conversions.

This report was discussed with Board officials and their comments were incorporated where appropriate.

CHAPTER 2

CONVERSIONS: A LIMITED ANALYSIS

Savings and loan associations have experienced restrictions on growth and problems in meeting net worth requirements established by the Federal Home Loan Bank Board. They saw a stock form of ownership as a means of growing and improving their net worth position. After many years of prohibiting conversions, the Board, in 1971, requested statutory authority to allow federally chartered associations to convert and still retain their Federal charter. Before this time, if an association converted, it had to give up its Federal charter and become a State chartered organization.

The Congress, in 1973, established a limit on the number of associations allowed to convert during a 1-year test period. This law was passed to protect the Federal savings and loan system from unrestricted conversions by Federal associations into State stock form. In 1974 the Congress extended the test period to June 30, 1976, and increased the number of associations allowed to convert from 8 to 49.

CONVERSION REGULATIONS

The Board issued regulations effective April 8, 1974, containing procedures for associations to follow in initiating and carrying out a conversion whereby stockholders replace depositors as owners. The regulations are intended to provide rules for conversions on an equitable basis. The rules include definition of terms; general principles for conversions; details to be included in the notice of filing, solicitation of proxies, and proxy statement; voting requirements; how to price and sell stock; and procedural requirements to follow from preconversion to postconversion.

The Board's basic regulations were revised in June 1975 and again in November 1976. The regulations were revised on the basis of changes in the law, analyses of conversion plans, discussions with other Federal agencies, and questionable practices occurring during and after conversion. In the Board's view, this is a test period and the regulations should be tested and revised as necessary. Violation of the Board's conversion regulations does not carry criminal penalty. In November 1976 a civil penalty was added which imposes a fine on persons connected with the association who violate the regulations prohibiting offers or transfer of subscription rights during conversion.

The Board stated that it monitors the conversion regulations by analyzing associations' plans and documents relating to conversions. It requests information from the associations and submits reports periodically to the Congress. These reports contain Board opinions and conclusions based on analysis of post conversion information requested from the associations. The Board does not review records at the associations unless a problem with the conversion has surfaced.

BETTER MONITORING OF BOARD REGULATIONS NEEDED

Our review at eight associations showed that the Board needs to increase its monitoring of associations to determine whether they are complying with conversion regulations. Activities at some of the associations indicate that regulations are not being followed. Increased monitoring with penalties for violations would result in more equitable conversions.

At some associations, members of management and their associates significantly increased their holdings through stock transfers soon after conversion. They also increased their savings accounts close to the expected record date of conversion, thereby obtaining rights to purchase stock to which they were not otherwise entitled.

Agreements to transfer stock

Board regulations specify that the conversion of an association be on an equitable basis to eliminate inequities in stock distribution. The regulations provide that eligible account holders receive nontransferable subscription rights to purchase shares to which they are entitled. To the extent available, rights may then be provided to other account holders, borrowers, directors, officers, and employees

At some associations, members of management and their associates significantly increased their holdings through stock transfers soon after conversion. In two associations we reviewed, there was activity which suggests that pre-arrangements could have been made which were prohibited by the regulations and which were not discovered by the Board.

At one association, 25,854 shares were transferred on the stock issuance date. Members of management acquired 21,592 shares, or 84 percent, of the total transferred. Some of these transfers to management can be traced to four individuals who, during the initial subscription offering, placed two separate orders. One stockholder

transferred 80 percent of his second order and three other stockholders transferred all of their second orders to members of management. The acquisition on the stock issuance date increased management's holdings from 5 to 31 percent.

At another association, a business associate of management and an estate for which a director was a coexecutor transferred 22,901 shares to a member of management within 3 months of the stock issuance date. This action increased total management holdings in the association from 16 to 20 percent.

In November 1976 the Board issued a regulation, to clarify the meaning of existing regulations, prohibiting any offers to purchase stock or transfer subscription rights during the conversion process. In addition, a Board official told us that an individual now certifies that he or she is buying shares for their own purpose and has no agreement with a member of management to transfer such shares to them. Although this certification was not applicable to the associations we reviewed, we believe agreements to transfer stocks will continue unless the Board closely monitors the implementation of its regulations.

Increasing savings accounts to buy more stock

At some associations, management and its associates increased their savings accounts close to the expected eligibility record date of conversion, thereby obtaining subscription rights to purchase additional stock to which they were not otherwise entitled. The Board's regulations require that management's savings accounts be reported if (1) the total savings account balances, including the accounts of associates, were more than \$40,000 as of the eligibility record date and (2) the accounts were increased by 25 percent during the preceding 6 months. The regulations do not cover management's accounts under the \$40,000 ceiling.

The association must report management's account balances as of the eligibility record date and each of the previous four quarters. (Effective October 1976, the data is required for the previous eight quarters.) The Board reviews all reported account balances for significant increases before the eligibility record date. A Board official told us that the association was asked to provide clarifications of increases where necessary. If the Board is satisfied with the explanations, management is eligible for the increased number of shares.

At one association, six accounts held by members of management or management-related interests were increased significantly thus allowing these individuals to actually purchase 7,030 more shares than without the increases.

At a second association, one account in the name of a director's business was increased significantly which allowed the business to actually purchase an additional 4,365 shares.

At a third association, one account in the name of a director's business was opened which entitled the director to purchase 4,482 more shares than without the account. The director did not purchase his full entitlement but did buy an additional 1,300 shares. The significance of this transaction is that the account was opened 2 months before the eligibility record date and closed 2 months later.

All these increased balances gave members of management subscription rights to purchase about 15,900 additional shares to which they were not otherwise entitled. Some of these account balances were over \$40,000 and some were under. Therefore, some of this activity was reported to the Board and some was not.

We believe that the Board needs to more closely monitor this type of activity because insiders can benefit. One way to do this is to review records at the association. In addition a regulation is needed for management and its associates' savings accounts under \$40,000. At small associations significant increases in accounts under \$40,000 can cause large increases in an individual's rights to purchase stock.

BOARD REGULATIONS NEED STRENGTHENING

Board regulations on rights under subsequent stock issues and the use of stock transfer agents may be working against the Board's stated conversion objective of broad participation with little or no benefits to insiders. In addition, the regulations relating to acquisitions of converted associations appear to contain provisions which could cause the Board significant problems.

Rights under subsequent stock issues

Associations converting under Federal charters are not permitted by Board regulations to have preemptive rights,

while State charters have the option depending on the State law. Preemptive rights are rights to maintain initial ownership percentage in all subsequent stock issues.

At one State chartered association, shortly after account holders and other investors paid about \$7.3 million for the initial stock issue, management announced plans to sell \$3.5 million in additional stock. It should be noted that management had acquired an additional 11 percent of the outstanding stock before the announcement was made. The association's charter had no provision for preemptive rights but for this subsequent issue of stock the association elected to assign rights to the outstanding shares of stock.

At another association, management considered a subsequent issue of stock because of the oversubscription on the initial issue. Because preemptive rights were assigned to the initial stock issue, the subsequent issue could only be sold to those who participated in the original issue. Thus, management decided against a subsequent stock issue.

The Board needs to determine the benefits and impact of permitting only some associations to have stock with preemptive rights. If the result of this determination is that this situation is not equitable, the Board should modify its regulations on rights under subsequent stock issues.

Stock transfer agent

Under Board regulations an association may act as its own stock transfer agent. Six of the associations we reviewed were acting in this capacity. At five of these associations there was an oversubscription of stock by the eligible account holders which precluded borrowers and depositors after the eligibility record from buying stock. The association, acting as its own transfer agent, can obtain information about potential transfers and direct such activity to its management. The following chart shows that management generally is acquiring the majority of shares traded in the secondary market.

<u>Association</u>	<u>Shares traded</u>	<u>Shares management acquired</u>	<u>Percent</u>
1	8,745	1,015	12
2	34,065	26,610	78
3	33,405	14,994	45
4	24,495	14,830	61
5	18,591	12,879	69

The National Housing Act defines control as obtaining 25 percent of an association's shares. By acting as its own stock transfer agent, management could be the first to receive information of offers to sell stocks, thus enabling it to increase present holdings. The following chart shows that members of management increased their holdings through secondary market acquisitions. Most of these increases enabled management to gain control of the association.

<u>Association</u>	<u>Percent of total shares management purchased in initial subscription</u>	<u>Percent of total shares management owned as of December 31, 1976</u>
1	28	28
2	5	39
3	19	30
4	20	35
5	20	27

As shown in the preceding charts, management is acquiring the majority of shares traded in the secondary market, and these trades enable them to gain control of the association. Therefore, the Board should determine if having someone other than the association act as a transfer agent would be advantageous to the Board's stated objective of broad participation with little or no benefits to insiders.

Acquisitions of converted associations

The Board determined that the capital receipts of a converted association could attract takeover attempts. Accordingly it issued regulations prohibiting, for 3 years following conversion, the acquisition of a converted association by a company significantly engaged in an unrelated business activity.

A holding company engaged in similar activity can acquire an association as soon as it has converted, subject to Board approval. Board regulations also prohibit, for 3 years after conversion, any offer which would result in

the offeror owning more than 10 percent of the association unless such offer has been approved in advance by the Board. When its approval is required under Board regulation, the Board needs to act more timely to prevent disputes.

At one association, a stockholder who was not a member of management, owned 14.4 percent of the stock. The stockholder later applied for Board approval to acquire an additional 8.1 percent which would give him 22.5 percent ownership in the association. Two months later, a savings and loan holding company agreed in principle to acquire this converted association. The stockholder, still waiting for Board action on the application, publicly opposed the acquisition by the holding company. At the suggestion of the Board's General Counsel, the association and the major stockholder entered into an agreement whereby the stockholder was offered and accepted a seat on the association's board of directors.

The Board through its delays may have raised some legal questions. For instance, had the savings and loan holding company acquired the association, the stockholder possibly could have sued the Board.

CONCLUSIONS

The question of equity and desirability of converting mutual associations to stock is not a matter which can be properly assessed through the limited experiment to date. Although the Board has learned much from the completed conversions, additional time is needed to monitor the conversion process, refine its regulations, and assess further the impact of conversions on the savings and loan industry.

Our review of eight associations did not provide sufficient information to permit us to properly assess the equity and desirability of conversions on an industrywide basis. However, we were able to identify activities which could prevent associations from converting on an equitable basis. Some insiders have increased their savings accounts to obtain additional shares of stock in anticipation of conversion and may have made arrangements to transfer stock soon after conversion. In addition, Board regulations on rights under subsequent stock issues, stock transfer agents, and acquisitions of converted associations need strengthening because they conflict with the objective of conversion-- broad participation with little or no benefits to insiders.

Improved monitoring procedures are necessary to better determine compliance with regulations, and penalties should be considered for persons who violate Board regulations. Also, the Board needs to revise its regulations to provide for more equitable conversions with less possibility of legal problems for the Board.

RECOMMENDATIONS

We recommend that the Congress limit the number of conversions through September 30, 1979. This limit should be similar to that expressed in Public Law 93-495. The time extension is needed to determine whether conversions are desirable and can be achieved on an equitable basis. During this period, the Chairman of the Federal Home Loan Bank Board should:

- Develop and implement monitoring procedures so that existing regulations are adhered to.
- Identify and seek legislative approval for needed changes in the law relating to penalties and enforcement authority to provide for equitable conversion.
- Strengthen existing regulations on rights under subsequent stock issues, stock transfer agents, and acquisitions by holding companies and others of newly converted associations.

AGENCY COMMENTS

We did not obtain written comments from the Board. However, the above matters were discussed with Board officials and they generally agreed with our conclusions and recommendations. The officials told us that they will take necessary actions to institute better monitoring procedures and to strengthen existing regulations. They further stated that the need for legislative authority in certain matters has been recognized by the Board.

CHAPTER 3

STOCK APPRAISALS--HOW GOOD ARE THEY?

To arrive at a value of a converting association, independent stock appraisals are made. The independent appraisals are reviewed by the Federal Home Loan Bank Board for completeness and accuracy. In the final analysis, however, the independent appraiser is responsible for the specific valuation, and the Board has relied on that opinion.

To determine adequacy of the appraisals, we reviewed each one for compliance with Board regulations and examined the stock valuation. Appraisals were largely based on appraisers' assumptions and judgments. We reviewed the qualifications and independence of each appraiser to determine if there were conflicts of interest which could have had an impact on the appraiser's quality.

BOARD REGULATIONS AND PROCEDURES

The Board's regulations require that an appraisal be made of the association's estimated market value. The regulations state that the appraisal must be prepared by persons who are independent of the converting association, experienced in the area of corporate appraisal, and acceptable to the Board.

Since the Securities and Exchange Commission does not require appraisals, no appraisal standards exist. The Commission allows the market to set the price. To compensate for the lack of standards, the Board developed guidelines which appraisers must follow. To achieve some uniformity in the various appraisals, the guidelines define the extent of data and degree of completeness expected. The guidelines were developed using the Board's experience and by consulting with securities experts. In addition, we noted the guidelines closely follow the Internal Revenue Service's guides for valuing stocks.

The Board's guidelines give instructions on methods and factors to be considered and require that an appraiser submit detailed discussions on appraisal assumptions. The guidelines require that the following be considered in appraisals.

- Present and projected economic factors for the general economy, savings and loan industry, and the association's primary market area.

- Competition and quality of management.
- Analysis of past and projection of future operating factors and earnings for the association.
- Projected net worth position.
- Anticipated dividends and tax considerations.
- Impact of increased net worth on savings growth and branching.
- Comparison with similar stock associations.
- Current equity market for savings and loans stock.

The procedures for performing an appraisal are (1) the association chooses an appraiser and notifies the Board, (2) the Board reviews the appraiser's qualifications and independence and then sends its guidelines to the appraiser, (3) before making the valuation, the appraiser discusses his approach with the Board, and (4) the appraisal is then completed and submitted to the Board for review and approval.

The Board's review includes a checklist to determine if the appraiser followed all the guidelines. The staff is in the process of partially automating the appraisal review, giving them easier access to appraisal statistics than is currently available. Because of this growing data bank, the appraisers will have more comparable data and should be able to make more accurate and reliable appraisals.

APPRAISAL METHODS

Three methods are commonly used by appraisers to price stock issues. These methods are (1) price-to-earnings ratio, (2) price-to-book-value ratio, and (3) capitalization of earnings or discounted dividends.

Price-to-earnings ratio

The price-to-earnings ratio method divides the current market price of a share by the earnings on each share for a 12-month period. The appraiser estimates the firm's ratio based on an analysis of the price-to-earnings ratio of other comparable firms with publicly owned and traded stock. The 12-months' earnings of the firm to be valued are multiplied by the selected ratio to obtain the firm's estimated market value.

A difficult task in using this method is finding a group of comparable stock associations whose stock is publicly traded with some regularity. The associations should be comparable; ideally, they should have a similar asset size, growth potential, quality of earnings, earnings potential, market location, and cash dividend policy. The selection of a ratio involves judgment even when the comparison associations match well because the comparables present a range rather than a single value. Thus, the converting association's ratio must be chosen from a range of values.

Appraisers estimate earnings by combining the anticipated earnings on current assets and the future earnings on the conversion net proceeds. To calculate the latter figures, the net proceeds are assumed to be invested in residential mortgage loans with a rate of return above that on the existing mortgage portfolio.

The price-to-earnings method has three major weaknesses:

1. For most of the converting associations, a comparable group of associations was not obtainable and often rough comparisons were used. These comparisons served only as guides, and the ratio selection involved a great deal of judgment.
2. For associations with low or negative earnings, the price-to-earnings method is inappropriate.
3. In the higher price-to-earnings range (above 10), even small errors in the assumptions about the appropriate ratio can lead to large errors in the appraisal.

The strengths of this method are based mainly on its predominant use. The majority of the industry's reference materials are based on the price-to-earnings method, and investors in today's market tend to be earnings orientated, and this method focuses on earnings.

Price-to-book-value ratio

This method is similar to the price-to-earnings method except the price-to-book-value ratio of the association replaces the price-to-earnings ratio, and the book value of the association's net worth replaces the earnings base. Using book value (or net worth) as a valuation method has three weaknesses:

1. It is a measure of historical value, while the appraiser is interested in current market value. The book value of the assets of a company or securities may have little or no significant relationship to market value. However, in some industries, book value is closely related to market value.
2. It ignores the company's earnings performance which is the interest of investors.
3. It is not appropriate for firms with low net worth positions because even small errors in the price-to-book-value ratio can lead to errors in the fair market value.

The strengths of the price-to-book-value method are much the same as those of the price-to-earnings method. Also, it is often used as a supporting valuation for the price-to-earnings method.

Capitalization of earnings or discounted dividends

This method views an association as an economic entity which yields the investor an expected cash dividend each year. From these expected payments, the investor can place a value on the stock, called its discounted value or present value. The method has a theoretical foundation and requires assigning a quantity to many assumptions.

The discounted dividends method forces the appraiser to be very specific about a number of parameters with much uncertainty surrounding the choice. An association's estimated value is very sensitive to the specific parameters chosen. Under the price-to-earnings method, judgment is applied to a few key factors. Under the discounted dividends method, judgment is applied to many factors, including the discount or interest rate factor, the expected cash dividend rate, and the expected earnings growth rate. There is also the important but difficult question of risk quantification.

The strength of the discounted dividends method is its ability to consider a multitude of factors and their effect on the final value. However, the amount of judgment required to select these factors is the discounted dividend method's obvious weakness.

The stock appraisal method used

The Board does not dictate which valuation method should be used but leaves it to the appraiser's discretion. For the eight conversions we reviewed, the price-to-earnings method was used with price-to-book-value as backup.

Whatever valuation method is chosen, certain factors must be considered when deriving the resulting value, such as:

- The local public image of the converting association.
- The initial discount necessary to insure marketing a public issue.
- The liquidity, or lack of liquidity, of the stock.

Criticisms of the price-to-earnings method

Critics of the early appraisals have stated that the price-to-earnings method ignores several important factors. For example, one claims that an appraiser does not consider an association's potential to sell to a holding company after it converts. However, the Board states that no quantifiable value can be associated with the potential to sell. The appraiser cannot speculate on this possibility or other future events. For example, what would be the impact on an association's earnings if legislation were enacted which would allow more services to be offered by savings and loan associations? Therefore, an appraiser must limit himself to more tangible and projectable factors.

The critics have also stated that in a conversion appraisal a premium should be included for the control feature management will obtain in its stock purchases. As discussed in chapter 2, management has gained control of the associations; however, Board regulations prohibit charging more for stock if it provides a controlling interest. According to Board officials, this regulation was implemented because it was difficult to define exactly what control was and how much it was worth.

The critics have stated further that the association's net worth, accumulated during its years as a mutual association, was ignored in any stock appraisal method using future earnings--thus the net worth would go to the stockholders. The Board requires that the association set up a liquidation

account for all eligible account holders in an amount equal to the association's preconversion net worth. This account guarantees an account holder liquidation rights over a stockholder until the account holder closes his account.

QUALIFICATIONS AND INDEPENDENCE OF APPRAISERS

The Board evaluates an appraiser's qualifications and independence. To date, no appraiser has been rejected. One individual and three firms made the appraisals of the eight associations in our review.

The individual appraised five associations. He is considered an expert in the field of savings and loan associations' activities, and his education includes degrees in insurance and a doctorate in finance.

The three firms are among the Nation's largest investment banking firms and are experienced in the underwriting, distribution, and appraisal of corporate securities. They are also experienced in the underwriting and appraisal of savings and loan securities.

All the appraisers were accepted by the Board as independent of the appraised associations. No officer or employee of the appraiser was a director of the association. Some of the appraisers' personnel could have financial relationships with the associations as depositors or borrowers. In one situation, the appraiser had securities transactions with the association and some of its senior officers. However, in each of these situations, the appraisers believed these relationships did not impair their ability to appraise the fair market value in an independent and professional manner. We could not verify this information because of the time required to gather the necessary data on all the financial aspects of employees of the investment banking firms and the associations.

Area of conflict

An association may elect to have the appraiser also serve as the underwriter, creating a potential area of conflict. The appraiser is allowed to underwrite for several reasons. He has the knowledge of market value and, through his underwriting syndicate, can estimate what the real market will pay. He is, therefore, in a good position to estimate market value.

Also, because of his liability, the underwriter performs the same type of review as an appraiser. To require an underwriter to duplicate the work done by the appraiser would cause the association to pay for the same work twice.

The Board holds that no conflict exists between setting the price and being responsible for selling the stock. It believes an appraiser would not set an incorrect price because his reputation is at stake. To most firms, their professional reputation means the success or failure of their business.

Another factor that offsets this potential conflict of interest is that if the price is set too high and drops afterwards, the firm is legally liable for any damages suffered to the stock organization. This, according to the Board, effectively precludes overpricing. An offsetting factor against setting the price too low is that an underwriter's fee is usually based on a percentage of the selling price of each share of stock he sells in the open market. If he sets a low price it causes a larger private subscription and less stock goes in the open market, thereby lowering his fee.

OUR EVALUATION OF APPRAISALS

Analyzing each appraisal for its reasonableness proved inconclusive. However, we noted that the method used by each appraiser was similar and that like data was used for comparable purposes. Board regulations and guidelines were followed in a reasonable manner.

Apart from compliance with Board regulations, we reviewed each appraisal for (1) accuracy of earnings projections after conversion to actual earnings and (2) stock price performance in the secondary market.

The two major factors in the eight valuations were the projected earnings and the price-to-earnings ratio. We found that the appraisers consistently underestimated projected earnings. However, the price-to-earnings ratios estimated by the appraisers were higher than the actual ratios when actual earnings became known. In two instances, the variances appeared significant. However, in both cases, large amounts of income were from unpredictable sources, such as joint ventures or the sale of land.

In considering stock price performance in the secondary market, we noted that the smaller associations trade in relatively small markets. None of the smaller associations' prices varied significantly, if at all, after the initial issuance of stock. Of the two nationally traded stocks, one was issued at \$9.25 in early September 1976 and the other was issued at \$14.50 in early April 1976. The first traded around \$9.25 for over 3 months before starting to climb and was trading at about \$11.00 in January 1977. However, on February 4, 1977, it jumped to \$11.75 a share. This increase was due to the announcement of a proposed merger of the association with a holding company.

The second stock remained relatively stable for a few months, then rose to about \$24 a share for a 64-percent increase. The association had increased its per share earnings 111 percent and assets \$243 million, or 53 percent. We compared these increases to the activity of the other stocks used in the appraiser's evaluation of the association. The price of these stocks increased 23 percent with an average per share earnings increase of 98 percent and asset increase of about 20 percent.

CONCLUSIONS

Appraisals involve considerable assumptions and judgments, and the appraisers are responsible for the specific value they assign to an association. We noted that the eight appraisals we reviewed were prepared by persons and firms independent of the converting association and experienced in the area of finance, economic conditions, and appraisal of corporate securities. Also, the appraisals were performed in a manner consistent with Board regulations and guidelines.

All the appraisals reviewed used the price-to-earnings ratio method. The price-to-book-value method was used only for support of the price-to-earnings ratio method. However, the appraiser always has a choice of which method he will use.

Because of the nature of the appraisal process, we could not assess the accuracy and fairness of the appraisal valuations for the associations reviewed.

CHAPTER 4

ALTERNATIVE METHODS OF INCREASING NET WORTH

To continue expansion, savings and loan associations are compelled to raise additional equity capital because of net worth requirements imposed by Federal Home Loan Bank Board regulations. These regulations require an insured association to maintain a net worth equal to or greater than a specified percentage of its savings deposits, plus 20 percent of certain association assets, such as delinquent loans and real estate owned as a result of foreclosures.

The sale-of-stock method of conversion has provided opportunities for an association to raise additional capital, expand their operations, and increase earnings. In the eight associations we reviewed, the primary reason given for converting from a mutual to stock association is the need to obtain additional equity capital to meet or exceed net worth requirements. This need occurred during a period when associations were experiencing a rapid savings growth.

While the sale-of-stock method has provided expansion opportunities there are other methods of increasing net worth. These include a distribution of free stock; sale of stock and establishment of a public trust fund; and sale of short-, medium-, or long-term subordinated debentures. These alternative methods, including their respective advantages and disadvantages, are discussed in the remainder of this chapter.

DISTRIBUTION OF FREE STOCK

In January 1973 the Board proposed a method where an association may convert from a mutual to a stock form of organization through a distribution of free stock. This method provides stock at no cost to savings account holders as of a specific date. The stock issue would be equivalent to the converting association's net worth at the time of conversion. It would be allocated on a pro rata basis. Those account holders who elect to pass up the stock would receive cash when any remaining shares are sold in the subscription offering.

The distribution of the free-stock method offers some of the benefits associated with the sale-of-stock method of conversion. These include increasing net worth by the

association selling future issues of stock and attracting and retaining management personnel through stock incentive plans. This method may invite wider participation by association members than the sale-of-stock method because if the stock is free, more members would probably be willing to accept the stock than if they had to pay for it.

The Board reexamined the distribution of free-stock method and concluded that it contains some drawbacks. The Board believes it could have a disruptive effect on the savings and loan industry. Depositors could shift their savings from association to association in anticipation of free stock, and mutual associations would be under pressure from depositors to convert to stock associations. Another drawback is that it does not result in additional equity capital or correct an association's low net worth position without a subsequent sale of stock. If this method is to be accepted, the Board and the associations would have to be convinced it is a viable method of raising new equity capital to increase net worth.

SALE OF STOCK AND ESTABLISHMENT OF A PUBLIC TRUST FUND

Under the public trust approach to conversion, stock is issued and sold in an amount equal to the market value of the converting association. However, unlike the current sale-of-stock method, the converting association does not keep all the proceeds from the sale of stock. Instead, proceeds equal to the net worth of the association before conversion would be deposited in a special trust fund under the Board's control.

The trust fund could operate similar to that of a revolving fund. Under one plan, moneys would be temporarily invested by the Board and later would be loaned directly to the savings and loan industry. Associations could borrow these funds at a low interest rate and use them for low- and moderate-income housing mortgages. Under another plan, moneys could be loaned directly to the mortgagee with the association servicing the loan.

One of the advantages of the public trust is that this method eliminates the possibility of insiders receiving a windfall profit. The windfall element relates to benefits accrued to stockholders when they acquire the association's existing net worth. Such benefits, proponents argue, may not be properly accounted for in the initial pricing of

association stock. Aside from eliminating the windfall element, the public trust approach offers some of the same benefits as the sale-of-stock method, such as raising more capital and attracting good management personnel through stock incentive plans.

The public trust method has some disadvantages. Critics argue the converting association is not provided sufficient capital to support savings growth since some of the money must be deposited in a trust fund. In addition, the Federal Government would have to maintain the public trust funds, and the fund would bear the cost. Only the moneys loaned directly to the savings and loan associations would benefit low- and moderate-income housing.

Board regulations do not disallow this method of conversion; neither do they promote it. Some procedures would have to be changed if an association were to convert under this method. However, it is questionable whether associations would proceed under this conversion method. No incentive exists for associations to deposit their proceeds in a public trust fund when under the sale-of-stock method they can keep them. Thus, for this method to be used, the Board would have to provide and enforce detailed regulations relating to the public trust aspect and the sale-of-stock method would have to be eliminated.

SALE OF SUBORDINATED DEBENTURES

The sale of subordinated debentures could offer associations another method of obtaining equity capital. Debentures are a form of bonds which are not secured by mortgages or property liens. They are subordinated to the claims of savings account holders and all other creditors. Since 1966 commercial banks and mutual savings banks have used this method as a means of meeting capital needs.

The sale of subordinated debentures, like the sale-of-stock method, could provide associations with additional capital. However, unlike the sale-of-stock method, debentures do not change the organizational structure of associations; that is, the associations remain as mutuals.

There are some disadvantages associated with offering subordinated debentures. The prominent argument is that under current regulations they are a liability and not part of equity; debentures must be repaid at maturity. Since Board regulations require that debentures be sold

in \$50,000 minimum amounts, purchases of the debentures may be limited to only large investors and institutions.

If debentures are to be a means of raising capital, not only must they be sold at an attractive interest rate, but the association must be able to receive a good rate of return on the investment of the proceeds. Another disadvantage is that in periods of depressed economic conditions associations must pay investors interest on their money; whereas with stock, dividends may not be declared.

Although the Federal Deposit Insurance Corporation regulations permit banks to include subordinated debentures in the capital structure as part of net worth, this is not permissible under current Board regulations. Thus, if subordinated debentures are to be a viable method of obtaining equity capital to meet net worth requirements, Board regulations must be revised to allow the recording of debentures as part of equity. In addition, to allow wider participation in the marketplace, regulations must be revised to allow debentures to be sold in denominations smaller than \$50,000.

CONCLUSIONS

A number of alternatives have been proposed as to how an association may obtain equity capital. Each has its advantages and disadvantages. However, for any of these methods to be used, present Board regulations would have to be changed. Also, some of these alternatives may not be attractive to the potential converting savings and loan associations and their use would have to be directed by the Congress.

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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 enough to result in the sale of all shares rather than at a price which reflects the real worth of the mutual enterprise. A corollary 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.

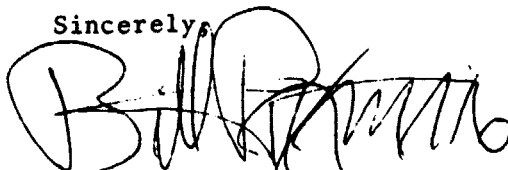
--An analysis of the price in relation to book value for which shares in stock savings and loan associations were acquired during the past five years and a comparison analysis of the price in relation to book value for which shares were acquired in converting institutions.

--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