"Windfall" Gains in Mutual-to-Stock Conversion of Thrift Institutions?

JAMES R. BARTH, R. DAN BRUMBAUGH, JR., AND ALLAN W. KLEIDON

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Congress should halt the mutual-to-stock conversions of thrifts, at least temporarily, in order to evaluate the entire process more fully.

When federally insured thrift institutions convert from mutual-to-stock-type organizational form, the initial stockholders reap significant—some say "windfall"—gains from immediate price appreciation. In 1993, as Table 1 (see page 44) shows, the depositors, directors and officers, and others who purchased the initial stock offerings in thrift ownership conversions whose gross proceeds exceeded $10 million reaped an average one-day gain of 29 percent. In 1992, the comparable figure was 24 percent. As Figure 1 (see page 45) shows, the one-day gains were as high as 58 percent in 1993 and 70 percent in 1992. Significantly, none of the conversions resulted in losses to those who purchased the stock.

While depositors, directors, and officers received these gains, taxpayers received nothing—either directly, or indirectly through the Federal Deposit Insurance Corporation (FDIC). Whether this distribution is equitable is questionable, given that insured depositors of the mutual thrifts were fully protected from risk by deposit insurance in the 1980s, while taxpayers have been required to pay most of the present-value cost of approximately $160 billion to resolve failed thrift institutions. Whether directors and officers should receive these gains is also an issue.

It is not surprising that congressional hearings, media interest, and court cases have arisen to determine if the appropriate parties were benefiting from such conversions. The public airing of these issues led the Office of Thrift Supervision (OTS)—the federal regulator for all federally insured savings and loans—to institute a moratorium on some conversions in early 1994. At the same time, while it did not impose a moratorium, the FDIC did begin to review more closely the conversion of state savings banks under its jurisdiction.

In the midst of this controversy, the issues we specifically address here are: (1) Does the conversion process itself generate "windfall" gains; (2) who should receive any gains from the conversion; and (3) who should be permitted to acquire institutions converting from mutual to stock form?

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Table 1
Summary of Initial Public Offerings

<table>
<thead>
<tr>
<th></th>
<th>1993</th>
<th>1992</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>IPOs greater than $10 million</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>12.7%</td>
<td>10.7%</td>
</tr>
<tr>
<td>Median</td>
<td>6.7%</td>
<td>4.2%</td>
</tr>
<tr>
<td>Weighted Average</td>
<td>12.5</td>
<td>9.3%</td>
</tr>
<tr>
<td>High</td>
<td>142.5</td>
<td>105.0</td>
</tr>
<tr>
<td>Low</td>
<td>(26.0)</td>
<td>(20.5)</td>
</tr>
<tr>
<td><strong>IPOs greater than $100 million</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>7.3%</td>
<td>4.2%</td>
</tr>
<tr>
<td>Median</td>
<td>4.3%</td>
<td>1.3%</td>
</tr>
<tr>
<td>Weighted Average</td>
<td>9.9%</td>
<td>4.6%</td>
</tr>
<tr>
<td>High</td>
<td>46.9%</td>
<td>25.6%</td>
</tr>
<tr>
<td>Low</td>
<td>(4.8)</td>
<td>(8.7)</td>
</tr>
<tr>
<td><strong>All thrift conversion deals greater than $10 million</strong></td>
<td>40</td>
<td>27</td>
</tr>
<tr>
<td>Mean</td>
<td>28.6%</td>
<td>24.4%</td>
</tr>
<tr>
<td>Median</td>
<td>27.8%</td>
<td>21.3%</td>
</tr>
<tr>
<td>Weighted Average</td>
<td>27.7%</td>
<td>22.0%</td>
</tr>
<tr>
<td>High</td>
<td>57.5%</td>
<td>70.0%</td>
</tr>
<tr>
<td>Low</td>
<td>0.0%</td>
<td>2.8%</td>
</tr>
</tbody>
</table>

1. Excludes Savings & Loan IPOs/Conversions, Closed End Funds and Offerings By Non U.S. Based Issuers
2. Weighted average based on market capitalization for all deals up to 11/1/93
3. Weighted average based on offering size

Source: National Investment Banking Firm (IPOs); SNL Securities (Thrifts) IPOs through November 15, 1993

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**Developing trends**

The conversion of thrifts from mutual to stock form of ownership is contributing to a significant transformation in the nation's thrift institutions. In 1980, about 20 percent of the thrift institutions regulated by the Federal Home Loan Bank (FHLB) were stock institutions. At the same time, virtually none of the savings banks regulated by the states were stock institutions. By 1993, however, about 50 percent of the thrift institutions regulated by the OTS—the FHLB Board's successor—were stock institutions. At the same time, roughly 30 percent of the state savings banks regulated by the states were stock institutions.

Before the mid-1970s, there was a series of regulatory impediments to mutual-to-stock conversions, including a congressional moratorium. Subsequently, however, Congress, and both state and federal regulators, took actions that facilitated such conversions. The primary motivation underlying this liberalization in the conversion process was to enable thrifts to improve their capitalization through the sale of stock and, thus, to increase the buffer that helps protect the deposit insurer from any deterioration of the thrifts. From 1980 through 1987, for example, 557 conversions were completed, with an initial sale of $9.7 billion in stock. There are still 1,240 mutual institutions controlling more that $230 billion in assets which may convert to stock form.

Many institutions that converted during the 1980s remained poorly capitalized despite the resulting capital infusions. Then, they pursued inappropriate strategies—such as excessive growth or paying excessive dividends or salaries. These tactics, in turn, led to the eventual seizure of a significant number of the institutions at substantial cost. Stock-type institutions, for example, accounted for 77 percent of the total estimated present-value resolution costs from 1980 through 1988.

More recently, institutions which have been converting have been, for the most part, better capitalized. This reduces the concern about whether the conversion process will result in inappropriate behavior by converted institutions. It does not necessarily eliminate it, however. In general, inappropriate behavior can still result, if deposit insurance premiums are underpriced or capital requirements are set too low.
Regardless of post-acquisition behavior, questions about the incentives of the officers and directors involved in conversions persist. Since the value of the stock issued during the conversion almost always appreciates immediately upon conversion, it is believed by many that the incentive to convert has been personal enrichment. As mentioned above, the average price appreciation within one day (following all thrift conversions with gross proceeds over $10 million) was 24.4 percent in 1992 and 28.6 percent in 1993. These figures, provided by Reid Nagle of SNL Securities, are far greater than the comparable figures for thrift conversions during the 1980s, when the industry was in turmoil and its survivability was being questioned.

In addition, the number of conversions with gross proceeds over $10 million has recently increased from twenty-seven in 1992 to forty in 1993. Ten states that had no conversions in 1992 had one each in 1993. There were five states with five or more conversions (Illinois [11], New York [9], Ohio [8], Missouri [6], and Wisconsin [5]); they accounted for 58 percent of all conversions in these two years.

**The conversion process**

The actual process followed during a standard mutual-to-stock conversion differs, depending on whether OTS or state regulations apply. In general, the OTS imposes more stringent limitations on purchases by officers and directors, and requires them to hold them for longer periods. Depending on the size of the converting institution, the OTS limits aggregate purchases of conversion stock by directors, officers, and nontaxed qualified employee stock-benefit plans to between 25 and 35 percent of the offering. In contrast, for example, Illinois places no limits on purchases by officers, but it does limit directors to 20 percent. Both Ohio and Wisconsin make no provision for limits on insider purchases.

This difference in regulatory restrictions may explain why some OTS-regulated thrifts have con-
verted to state-regulated savings banks before conversion. It may also help to explain why Illinois, Ohio, and Wisconsin account for 36 percent of the conversions that occurred in 1992 and 1993. Due to a state law that became effective in August 1990, Illinois became the first state to approve switching from a thrift charter to a state savings bank charter. A similar law became effective in Ohio in October 1991. These developments raise the issue of whether Congress should take action concerning the conversion of federally insured mutual savings and loans to state-chartered savings banks—for the purpose of then converting to stock ownership.

The general conversion process is as follows: The officers prepare a plan of conversion which is submitted to the directors for approval. Once approved, the plan, in turn, is submitted to the depositors, who are viewed as the owners of mutual institutions, for their approval. With the approval of the directors, depositors, and appropriate regulatory authority, the stock is then offered for sale through nontransferable subscription rights issued to individuals—according to a specified order of priority. This priority scheme depends upon whether the conversion is governed by OTS or state regulations.

On the day of conversion, the stock is sold at a price based generally upon an independent valuation. This valuation is supposed to take into account the value of the existing institution and the use to which the proceeds from the stock sale (net of legal, appraisal, and underwriting costs) are to be put. The OTS and, previously, the FHLB, have expressed concern that the stock not be “underpriced.”

Despite this concern, the post-conversion increases in the value of the stock indicate that underpricing was the norm for recent conversions. In 1992, three months after the initial public offering, the average percentage increase in share price was 42 percent, and ranged as high as 105 percent. At year-end 1993, the best performance for a 1992 conversion was obtained by United Postal Bancorp, Inc. of Missouri whose offering price of $5 had increased 445 percent to $27.25. In 1993, in three months, the average percentage increase in share price was 40 percent, with a high of 55 percent. At year-end 1993, the best performance for a 1993 conversion was obtained by Hamilton Bancorp, Inc. of New York, whose offering price of $10.80 had increased 84 percent to $19.875. These returns are extraordinary, especially because there is little or no risk that the initial offering price will decline at the time of or shortly after conversion.

**Policy concern: “windfall” gains**

The major policy concern about conversions seems to be that officers and directors (or, more generally, insiders) may be reaping “windfall” gains directly through stock purchases. There are also concerns that insiders may be reaping further “windfall” gains indirectly, in the form of stock obtained through various performance incentives and retirement programs—at the expense of depositors. It is important, especially given the former concern, to understand the reason for the aftermarket appreciation in the stock prices that accrues to the initial stockholders.

The key fact that distinguishes mutual-to-stock thrift conversions from other initial public offerings is that the proceeds from the initial stock sale do not go to the owners of the institution—that is, the depositors. Instead, the proceeds (net of legal, appraisal, and underwriting costs) become an asset of the new stock institution. This means that the initial stockholders have a claim, not only on the assets of the pre-existing mutual institution, but also on the new asset—the proceeds from the stock sale at the time of conversion.

The fact that the proceeds from the initial sale of stock do not go to the owners or depositors but, instead, are retained within the thrift means that, once the stock is offered for resale to the general public, it should rise in value. The marketplace will value the new institution as the sum of the pre-existing institution’s net worth or capital plus the additional estimated present value of the profits to be obtained from the proceeds from the stock sale (since the proceeds remain at the thrift). Only for thrift institutions with no pre-existing value at the time of conversion and no prospects for profitable use of the proceeds from the initial stock sale would one anticipate no appreciation in the stock. In such a situation, however, one would generally not expect to see a conversion attempted.

In all other cases in which the thrift has pre-existing value, and the sale proceeds can be put to profitable use, the value of the stock will increase above the purchase price, once the stock is made publicly available. It is as if the initial stockholders have gone
to a candy store and purchased a candy bar. In return, however, they receive not only the candy bar, but also what they paid for it.

The fact that a “windfall” gain occurs, or that the initial stock is underpriced, therefore results from the unique nature of the conversion process itself, in which the sale proceeds go into the institution instead of to the owners. This applies to all mutual-to-stock conversions, regardless of whether they are subject to OTS or state regulations.

**Thrift vs. nonthrift IPOs**

The question naturally arises as to whether any apparent underpricing in thrift initial public offerings (IPOs) is due to the IPO process itself, rather than to the mutual-to-stock conversion process. This is particularly pertinent, since there is an extensive literature documenting that there appears to be a general phenomenon of underpricing in IPOs. On average, IPOs have consistently shown substantial returns in initial trading following the issue. Average initial-day returns for IPOs in the United States have averaged about 15 percent from 1960 to 1992, and similar results have been found overseas.

Although several explanations of this general phenomenon have been suggested, we emphasize that the extent of underpricing in thrift conversions is much greater than for IPOs in general, as shown in Table 1. In contrast to the 24.4 percent and 28.6 percent underpricing for thrift conversions in 1992 and 1993, a national investment banking firm reports that nonthrift IPOs (also greater than $10 million) experienced underpricing of 10.7 percent and 12.7 percent in 1992 and 1993, respectively. While the degree of underpricing for nonthrift IPOs in 1992 and 1993 is similar to the 1960–92 average, the underpricing in thrift conversions is over twice as large as nonthrift IPOs in both years.

Moreover, Table 1 and Figure 1 show that, in 1992 or 1993, no thrift conversion resulted in losses to those who bought the new stock. This is in strong contrast to IPOs in general. Of the 341 nonthrift IPOs in 1992, for example, the price, one month later, was less than the IPO price in over 30 percent of the cases, and resulted in losses to the initial purchasers.

Suggested explanations for the general IPO underpricing phenomenon commonly rely on asymmetric information about the value of the new issue. While it is true that, on average, the price in the secondary market is higher than the initial offering price, there is also very high price variance in the secondary market. It appears to be very difficult to predict which offerings will experience significant price appreciation in the secondary market, and which will decline in price. This large uncertainty about the price performance after the offering is the basis for most suggested explanations of the average underpricing.

One explanation is that investors who have relatively poor information about which IPOs will be winners and which will be “dogs” will systematically lose, relative to better-informed investors. Since the winners tend to be oversubscribed, many investors will receive only a small fraction of their orders for these IPOs. However, if an IPO is a likely underperformer, the better-informed investors know to avoid the issue, and it will tend to be undersubscribed. The relatively poorly informed investors thus suffer a form of winner’s curse: They will find that they get all the shares they request when the issue (a subsequent poor performer) is undersubscribed, but only a fraction of their order when the issue turns out to be a winner. Under these conditions, the uninformed investors will require positive expected returns—that is, underpricing—to compensate them for the winner’s curse they face.

This argument, and similar models that rely on asymmetric information about whether the IPO will be a subsequent winner or loser, have little relevance to the thrift-conversion phenomenon, since there is very little risk that the conversion will create a loser. Although a large proportion of general IPOs turn out to have negative returns when they begin trading in the secondary market, this is simply not the case for thrift mutual-to-stock conversions.

The degree of underpricing for thrift conversions is truly a separate phenomenon from that of standard IPOs. This is not surprising, since the special characteristic of the mutual-to-stock conversions is the retention of the IPO proceeds within the thrift after conversion, without separate compensation to the original owners.

**Policy prescriptions**

As long as a mutual institution has value at the time of conversion, and someone is willing to pay to acquire the initial stock offered in a conversion, gains

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will be reaped from the sale, regardless of the nature of the conversion process. One question is which parties should reap the gain. If the depositors, for example, purchase all of the stock at the time of conversion, the gain will go to them. Conversely, if the insiders purchase all of the stock, they will receive the gain. If Congress were to decide to redistribute gains to depositors, it could place greater restrictions on the stock purchases of insiders and, simultaneously, encourage depositors to purchase more shares when any institution converts.

Without other changes in the current conversion process, such an action would not eliminate “windfalls” or underpricing; it would, however, better ensure that depositors share more fully in any gains. Alternatively, one could distribute shares of stock freely to all depositors on a pro rata basis determined, for example, by the amount of their deposits and tenure as depositors. This would allow depositors to be reimbursed for their ownership claim to the mutual institution by selling their shares, once a conversion has occurred. This action would mean that the proceeds from the stock sale would flow directly to depositors, not to the institution, and would thereby curtail “windfalls” or underpricing.

One must, however, question the extent to which depositors deserve to benefit from any gains from a mutual-to-stock conversion. The reason for the question is that, to the extent that their deposits are federally guaranteed, they are not generally “owners” in the true economic sense of that word. Owners are usually the individuals who place their funds at risk. Federally insured depositors, however, do not have any funds at risk. When mutual thrifts were established in the early 1800s and depositors became “owners,” their depositors did, indeed, place all of their funds at risk. Since the 1930s, instead of the depositor, it is the federal insurer and the taxpayers who have been at risk. For this reason, proceeds from the sale of stock resulting from conversion may most appropriately belong to the insurer to hold as the agent for taxpayers.

There are potentially important nuances to this general statement. Under some circumstances, federally insured depositors may have contributed to the accumulation of capital in some insured thrifts. In the 1980s, some depositors at some thrifts may have been willing to accept rates of return on their insured deposits which were below what they could have received elsewhere. They did not, for example, move their insured deposits to thrifts that were growing rapidly and funding inappropriate strategies with the use of higher rate-paying brokered deposits. As a result, the thrifts in which the depositors remained may have benefited from increased net worth or capital as a result of their lower-cost deposits. To the extent that subsequent conversions reflect the value created by depositors, the depositors may have a claim on that value at the time a conversion takes place.

Whoever is to benefit from a conversion—insiders, depositors, or the insurer/taxpayer—the best way to generate proceeds may be to permit any legally permitted parties to bid on the acquisition of any and all mutual thrift institutions, so as to convert them to stock institutions. This would include the possibility of acquisition by parties completely unrelated to existing management or members of the board of directors of a potential thrift conversion. In general, the larger the number of permitted purchasers, the more likely the resulting price will reflect the true market value of the thrift at the time of conversion.

Resolving the issues

The three major issues that confront Congress are (1) whether to attempt to reduce the “windfall” returns that currently are earned by “inside” stock purchasers in mutual-to-stock conversions of thrift institutions; (2) who should be the beneficiaries of whatever gains arise from stock conversion of mutual institutions; and (3) who should be allowed to bid for stock in a mutual conversion.

As we have discussed above, the source of the “windfall” returns is the unique quality of mutual-to-stock conversions of thrifts, insofar as the cash proceeds of the sale become an asset on the books of the savings and loan. If the proceeds instead flowed to the parties with legitimate ownership interests in the institutions, the essential source of the “windfall” returns would be removed. Thus, one way to eliminate the “windfall” gains would be to require that all proceeds be paid out to the appropriate owners.

An example of this approach would be to distribute ownership rights to depositors of all existing mutual institutions based on the amount of their
deposits and the length of time they had been depositors. Other candidates for ownership shares are the taxpayers. Taxpayers bear the ultimate financial responsibility for deposit insurance in federally insured depositories; they have borne the major financial burden for the savings and loan debacle. How does this affect the issue of who should be able to claim ownership of mutual thrifts? As discussed above, true economic ownership should generally reflect who is actually at risk, if the economic fortunes of a mutual institution falters. The officers and directors of a thrift presumably are compensated for such risk by the salaries and fees they receive. Insured depositors, who have been the overwhelming majority of depositors at thrifts, bear no risk at all. The ultimate risk is borne by taxpayers.

Under these circumstances, one can argue that insured depositors ought to have a limited ownership claim in the event of a mutual-to-stock conversion—for example, based on the extent to which depositors contributed to the accumulation of capital by forgoing high interest payments. A strong argument can be made that the majority of the ownership interest in a mutual institution should be assigned to taxpayers.

There are a number of other issues as well. Should Congress examine in detail who has benefited from the dramatic increases in conversion stock prices? Would it be appropriate, under some circumstances, for Congress to require that some or all of the "windfall" be rebated to the insurer or taxpayer? In the process of effecting conversions, were excessive legal, appraisal, or underwriting fees charged in the preparation of the conversions? Should some of these fees be rebated?

Resolving these issues is going to be difficult and contentious. Under the circumstances as we have described them, we think that the moratorium established by the OTS and the greater scrutiny by the FDIC are appropriate. We would, nonetheless, recommend that Congress reinstate a moratorium on all conversions, while it undertakes to resolve whether the gains that we have described should be eliminated, and to determine who should be able to gain from conversions that take place in the future. As it stands now, the conversion process may be distributing inappropriate "windfall "gains to insiders. It seems appropriate for the Congress to halt the conversions, at least temporarily, in order to evaluate more fully the entire conversion process.