Credit Union Conversions: Ripe for Abuse … and Reforms
-by James A. Wilcox, Ph.D.

Few issues generate stronger emotions or wider ranges of opinions than credit union conversions. Skepticism about the motivations and misunderstandings about the processes for conversions are pervasive. Understanding is increasing, however, that conversions raise many salient issues: How should and do credit unions differ from banks? Who does and should benefit from conversions? What does it really mean for members to own their credit unions?

As conversions continue, what will also become increasingly understood are that the current conversion process fails members and that reforms can readily improve understanding, improve decisions about whether to convert, and improve fairness to credit union members.

In a newly released Filene Research Institute research report, *Credit Union Conversions to Banks: Facts, Incentives, Issues and Reforms*, I develop a framework that clarifies what the various costs and benefits would likely be to members, managers, and outsiders. I also propose readily available reforms that would provide more rewards to the members who contributed more to the value of their converting credit unions. In that regard, my proposals make credit union member-ownership really worth something.

Fair Shares

Credit unions may offer lower loan rates and higher savings rates than their competitors. On the other hand, conversion to a stock-owned institution offers members the opportunity to own shares that can be turned into cash. One way to judge whether to convert is to compare the value of members' future credit union benefits to the value of their shares in a converted institution.

The better a credit union's product offerings, rates, operational productivity and member services, the less compelling is the case for its conversion. By contrast, relative to the benefits that it offers, the more net worth that a credit union has, the more attractive and justifiable to members will be its conversion. For example, a credit union that charges its borrowers and pays its savers interest rates that are about the same as those of its stock-owned competitors and that has a high capital ratio may benefit its members more by converting. But, this relies on members' getting their fair shares. So far, regulations effectively prevent members from getting their fair shares. That can, and should be, fixed.

Current mutual-to-stock conversion regulations for thrifts and banks provide members with the right to buy shares of stock in the converted institution. When members have to pay up if they want to own any shares in the converting institution, which they are presumed to already own, we should be concerned that something is seriously amiss. And it is.

The number of shares each member is entitled to purchase is linked to the member's *pro rata* share of deposits as of some eligibility date. History demonstrates that few members actually purchase shares. Typically fewer than 1 out of 10 members of converting mutual thrifts have purchased shares. Purchasing no shares, they get none.

Shares that members forego are then offered to others—management, board members, and outside investors. All of those who do purchase shares then have ownership of both the purchase amounts that they contributed—plus the retained earnings and the often-considerable ongoing-enterprise value of the converting institution. The ownership surrendered by members who didn't fully exercise their right to purchase shares then accrues to everyone who did. The typical one-day gain for purchasers has been about 19 percent.

As a result, the current conversion rules distort the incentives of almost everyone to convert. The rules make it difficult for most ordinary members to accurately see how they might benefit from converting. At the same time, the rules can make it lucrative for management, board members and outside investors to convert.

Rewarding Total Contributions

Members should not have to purchase what is ostensibly theirs. In my report, I propose that members be given, at no charge, the shares of their converting credit union.

I also propose how to distribute the most shares to the members who contributed the most to the value of converting credit unions. Current conversion regulations are inspired by court rulings, some dating as far back as the late 1800s. Even then, courts noted that the simple deposit-based, eligibility-date method was not "just and equitable," but, rather, was "a rule of convenience and necessity" and that it invited "eleventh-hour people to come in as depositors." Record-keeping has advanced since the late 1800s, and so should regulation.

I propose that shares be distributed to members based on their long term contributions to the credit union. Distributing shares instead of selling them would reduce--if not eliminate--the opportunity for insiders and for outside investors to expropriate the ownership shares of ordinary members. Using average savings over the prior 5 or 10 years--or since computerized records are available--to determine share allotments would dramatically reduce incentives for late depositors. To allow for the considerable contributions of borrowers to the value of converting credit unions, share allotments could also weigh past loan, as well as savings, balances.

I also propose distributing only stock, and not cash, and somewhat restricting the right to sell one's shares during a short transitional period. Since members had not been able to access that capital for decades, waiting a few more months does not seem a particularly undue restriction.

My proposal would not require new legislation from Congress or changes in regulation from the NCUA. Current mutual-to-stock conversion rules apply to mutual thrifts, but do not apply, for instance, to credit union-to-commercial bank conversions. As far as I can tell, there is no US law or NCUA regulation that precludes a credit union from using my proposal to convert directly to a stock-owned, commercial bank.

These reforms appeal to our judgments about economic efficiency and our sense of fairness. Reform will make for a more vibrant industry. Reform will offer a fair and sensible exit route for currently well-capitalized, but ultimately uncompetitive, credit unions. It will also discourage exit by credit unions that have well-served members and thus well-capitalized and profitable futures. Together, these reforms will better sort out which credit unions convert and better sort out the rewards to the members who contributed to the value of their credit unions.

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