

August 11, 2006

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Credit Union National Association	National Credit Union Administration
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Reference: CUNA's Request for Regulatory Comments on NCUA's Proposed Credit Union Conversion Rule and Comments Due CUNA (August 14, 2006) and NCUA (August 28, 2006).

I. **EXECUTIVE SUMMARY:**

¹The NCUA is proposing to amend its rules on the conversion of insured credit unions to mutual savings banks or mutual savings association. The amendments are primarily intended to improve the information available to a credit union's members and its board of directors as they consider a possible conversion.

The proposal requires a converting credit union to give advance notice to members that the board intends to vote on a conversion proposal and establishes procedures for members to share their views with directors before they adopt the proposal.

The proposal clarifies that credit union directors may vote in favor of a conversion proposal only if they have determined the conversion is in the best interest of the members and requires the board of directors submit a certification of NCUA of its support for the conversion proposal and plan. The "boxed" disclosures that a credit union must provide to its members are simplified and the current delivery requirements changed.

Under the proposal, the member ballot must be sent only with the 30-day notice. Board of directors would be required to set a voting record date not less than one hundred twenty days before the board notifies the members it is considering adopting a conversion proposal.

After the board has approved an MSB conversion proposal and upon the request of a member, the proposal requires a credit union to disseminate information from that requestor to other members at the requestor's expense. Members of federally chartered credit unions ("FCUs") may request and be granted access to the books and records of a converting credit union.

The proposal requires the NCUA Regional Director to make a determination to approve or disapprove the methods and procedures for the membership vote within thirty calendar days of the receipt of the credit union's certification of the member vote and permits any credit union dissatisfied with the determination to appeal to the NCUA Board for a final agency determination.

A credit union would be required to complete a conversion within one year of the date of receipt of final approval from NCUA of the methods and procedures of the vote. The voting guidelines are modified to include information on the use of voting incentives such as raffles.

BACKGROUND:

Under the Federal Credit Union Act (FCUA), federally insured credit unions (FICU) may convert to a mutual savings bank or mutual savings association (MSB). NCUA first adopted a rule specific to

¹ Excerpts from CUNA Comment Conference Call

conversions in 1995 and included required voting procedures and disclosures to properly inform members. Two of the stated purposes of the rule were:

- To ensure that transactions take place only pursuant to an informed vote of the credit union's member-owners; and
- To prevent self-dealing and other abuses by individuals involved in the transactions.

Congress adopted the Credit Union Membership Access Act (CUMAA) in 1998, which contained several provisions on the MSB conversion process. Among its requirements, CUMAA states:

- That a majority of directors must approve a proposal to convert;
- That approval of the proposal shall be by the affirmative vote of a majority of the members of the credit union who vote on the proposal;
- That a credit union provide members notice of the vote 90 days, 60 days, and again 30 days before the vote, and also provide the NCUA Board notice of its intent to convert;
- That there be restrictions of directors' and senior management's ability to receive economic benefits in connection with the conversion.

CUMAA also requires that NCUA administer the membership vote on the conversion and empowers NCUA to disapprove the procedures applicable to the member vote or the methods by which the member vote was taken. NCUA must also adopt rules governing MSB conversions, which must be:

- Consistent with the charter conversion rules promulgated by other financial regulators; and share with members clearly and conspicuously that a vote for the proposal means the credit union will become a bank, while a vote against the proposal means that the credit union will remain a credit union.
- The ballot may also indicate whether the board recommends a vote for or against the proposal, but may not contain any other information.

II. ²CREDIT UNION COMMENTS ON PROPOSED CONVERSION RULE:

A. Suggested Additions to / Changes in Required Boxed Disclosures:

Since the primary purpose of a credit union is to serve the members who own the institution and to build capital that ultimately inures to the benefit of the member/owner, we believe that the wording/disclosures in the proposal Rule sent to us needs considerable improvement to be of significant value to the member serving the credit union purpose.

We constructively suggest that CUNA, and ultimately NCUA, consider the following improvements in the requested Conversion Rule from two (2) distinct approaches in conversion format:

- Standard conversion from a credit union to a mutual thrift (MSB) and ultimately to a stock institution, and
- Variant of the standard conversion model, where NCUA would permit a credit union, otherwise meeting all of the disclosures and process requirements, to convert directly to a stock institution (commercial bank).

1. Standard conversion to a mutual (MSB) and ultimately to a stock institution (commercial bank) – REQUIRED BOXED DISCLOSURES
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OBSERVATIONS: The current proposal for *Required Boxed Disclosures* appear weak and uninformative to a member inexperienced in the ultimate financial impact and outcome of conversion for the *mutual to stock* entity; especially as it relates to the objective of presenting a valid claim to a *pro rata* share of retained earnings in the credit union.

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The proposed new Required Boxed Disclosures should be presented in plain language that sets forth the effects of a member voting “for” conversion and that the credit union will become a bank. Disclosing that a vote “for” conversion means the credit union will become a bank is telling the voting member nothing of value as it relates ultimately to preservation of their *pro-rata* shares in retained earnings.

Think about it for a moment in practical, rather than theoretical terms. The credit union member today thinks and views the institution in different terms than the member thirty-years (30) ago. First, many members innocently refer to their credit union as a “bank” today, simply because traditional financial services and banking products are “commoditized” with little surface differentiation. Second, most members do not think about the relative value of a claim upon retained earnings. The current wording should be enhanced to allow more information to the voting member.

According to the Filene Research Institute Study (2006):

³*The NCUA has released additional regulations (final rules dated February 25, 2004 and January 13, 2005 included in NCUA Rules and Regulations) requiring converting credit unions (1) to provide their members with a series of additional disclosures and (2) to use certain voting procedures in conversions (NCUA 2005: 103 and 6).*

SUGGESTION #1:

The regulations also require that (and we suggest that this proposal include) credit unions send their members a standardized boxed disclosure drafted by the NCUA stating:

- *That members with larger balances in mutual thrifts may have more control,*
- *That mutual thrifts compensate their directors and pay corporate income taxes potentially leading to higher loan rates, lower savings rates, and higher fees for services,*
- *That executives obtain more stock than regular members in subsequent mutual-to-stock conversions, and*
- *Estimates of the costs of conversion broken down across several categories.*

SUGGESTION #2:

⁴*The proposed should also be revised to include the following “Blocked Language” which would more clearly and completely explain the importance of their discussion and vote!*

³*Under current OTS (and FDIC) mutual-to-stock thrift conversion regulations, if members approve a conversion, their joint claim on retained earnings is not exchanged for shares of stock or cash in proportion to their deposits. Instead, upon conversion, their pro rata claims on retained earnings are exchanged for:*

- (1) Individual, nontransferable, preferential rights to purchase stock and*
- (2) Individual claims to retained earnings that would be senior to those of stockholders in liquidation.*

However, if members (as a group) do not purchase all of the shares of stock that are offered in the IPO, then they will, in effect, surrender their claims on retained earnings. In that case, in effect the retained earnings will accrue to external investors that do purchase the stock at the IPO. If individual members purchase some stock, but less than their pro rata share of the deposits entitles them to purchase, members will have partially surrendered their claims on the thrift’s retained earnings.

SUGGESTION #3

In a creative sense, rather than simply disclosing that a vote to convert means ultimately being a “bank”, it may be more helpful and certainly more informative and objective to cite the common, well

³ Excerpts from *Credit Union Conversion to Banks: Facts, Incentives, Issues, and Reforms* publication, Filene Research Institute

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known advantages and disadvantages of conversion when properly disclosed to the members, retained earnings being protected for *pro rata* distribution.

Specifically, regulators might consider blocking the following general language in notation to the member: “Should you vote for conversion to a MSB, some of the advantages of mutual thrift charters over a credit union charter are:

- ⁵ (1) *Absence of a field of membership that restricts growth of depositors and borrowers and reduces the risks of having a single employee group or geographic area,*
- (2) *More generous limits on investment and lending powers (e.g., business lending, commercial real estate, corporate bonds),*
- (3) *Better ability to diversify lending portfolios outside of the highly competitive auto and consumer lending markets,*
- (4) *Greater scope for compensating directors financially and attracting higher-quality directors who might exert more effort to monitor management,*
- (5) *Avoiding having to deposit one percent of insured shares in NCUSIF and, currently for nearly all FDIC-insured institutions, not having to pay insurance premiums at all,*
- (6) *Lower effective capital requirements and greater flexibility in raising capital quickly (e.g., via issuing subordinated debt), and*
- (7) *Greater ability to convert further (to stock thrifts and commercial banks) and thereby⁵ ease the raising of capital!*

⁶SUGGESTION #4:

The NCUA should ensure that the board of directors of a credit union contemplating conversion:

- (1) Have an independent fiduciary analysis of the pros and cons of conversion to include certification of the book and market value of capital at date of member vote and the appropriate exchange ratio for retained earnings
- (2) Communicate that information to the membership, prior to the vote, in anticipation of a conversion to a mutual thrift and ultimately to a stock institution.

The most recent example of a need for this type of analysis is the Nationwide Federal Credit Union merger over to a national bank. The good news in the merger is that members received a 23% premium for their *pro rata* share of capital; the bad news is that it did not appear sufficient... thus, the need for accurate in-depth analysis.

Implementing Suggestion #4 would certainly give the membership an accurate analysis of the fair market value (FMV) of capital and inform them appropriately for the conversion vote. However, this suggestion, if implemented, falls short in that NCUA’s authority ends with the conversion to mutual – whether mutual stock or mutual thrift – thus no assurances that current members would receive their *pro rata* share of capital. This could be accomplished with verification in the conversion by going directly to a stock institution.

2. Variant of the Conversion Model – From Credit Union Directly to Stock Institution (Demutualization).
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The Filene Research Institute’s strategy – “*Credit Union Conversion to Banks: Facts, Incentives, Issues, and Reforms (2006)*” presents a variant of the conversion that it thinks the NCUA could implement **without new legislation.**

⁵ Excerpts from *Credit Union Conversion to Banks: Facts, Incentives, Issues, and Reforms* publication, Filene Research Institute

⁶ Coastal Federal Credit Union

SUGGESTION #5:

Specifically,⁷ the NCUA could **permit credit unions to convert directly into (stock) commercial banks.** Shares of stock in the bank would be distributed to members in proportion to their historical savings and/or borrowings. This variant would reduce the transfers from members who, under current OTS and FDIC regulations, do not receive all, and typically do not receive any, of the retained earnings when their mutual thrifts convert⁶ to stock institutions.

The NCUA might want to consider the following four (4) safeguards to strengthen the conversion model for the benefit of members.

1. Limit incentives for Professional Depositors to Participate in Demutualization's.

To limit the incentives for professional depositors to participate in credit union demutualization's, the NCUA might consider (1) weighing savings and loans by length of time in calculating conversion rights or (2) granting conversion rights only to longer-term members.

2. Enhance Ability to Raise Capital and Liquidity of Shares.

To ensure that demutualization's do not prevent institutions from raising capital and to enhance the liquidity of the shares, the NCUA might explicitly permit institutions that demutualize to simultaneously hold standard IPO's (i.e., ones in which new stockholders have claims only on the funds they contribute and not on those of non-buying members). Of course, direct conversions from credit unions to commercial banks would require close cooperation between the NCUA and bank regulators.

3. Minimize Deviation In Value Between Value First Received by Members: Their Pro Rata share In Retained Earnings.

To reduce how much the value first received by members deviates from their pro rate share of retained earnings, credit unions might distribute shares of stock rather than cash, and restricted formerly-non-tradable member claims would become fully-tradable shares. For instance, rules might allow members to sell, subsequent to the conversion, up to one-fourth of their shares during the first quarter (or year), and up to three-fourths of their shares during the first three quarters (or years). This approach would prevent small shareholders from opting for unfavorable cash payouts or from depressing prices in the short term if many small shareholders tried to unload their shares simultaneously.

4. Credit Unions Commit to Purchase Shares at Market Price Without Charging Commissions.

Since brokerage commissions are likely to detract a far larger percent of the value of shares sold by small stockholders, former credit unions that demutualize might commit to purchase shares at market prices from small stockholders directly for an extended period of time without charging commissions. The maximum amount of shares that former credit unions would be committed to purchase directly could be capped at, for example, \$1,000 per member. The number of direct purchases that a former credit union would be committed to make could also be capped, for example, at four purchases per member.

CONCLUSIONS

The Filene distribution concluded that these demutualization proposals would address many of the concerns of conversion critics. In particular, these proposals would prevent transfers of claims on retained earnings from non-buying members to buying members (including managers and directors) and external investors. If the option of conversions under the demutualization model were introduced, when individual credit unions and boards of directors responsibility for informing the membership could (1) point out the types of compensation received by members under different conversion methods and ask for separate votes on (2) whether to convert and (3) what conversion method to use. Further, if these proposals were implemented, professional depositors would have far weaker incentives, if any, to participate in conversions. It is also unlikely that typical members would push for conversions under either the standard method of the demutualization model.

⁷ (All italicized text on this page) Excerpts from Credit Union Conversion to Banks: Facts, Incentives, Issues, and Reforms publication, Filene Research Institute

More importantly, to the extent that managers, directors, and members of credit unions seek conversions due to disadvantages in their charter, rather than to engineer transfers of claims on retained earnings from non-buying members, introducing the option of a demutualization model would not restrict charter choice for individual credit unions. Under the demutualization model, individual credit unions that concluded that they could provide more value to their members by foregoing fields of membership and adopting a stock structure could do so.

⁸It is our opinion, having reviewed the Filene Research Institution's detailed research and constructive recommendations that the NCUA should completely re-think and communicate to the board of directors of all credit unions the requirement for an independent, detailed third party analysis of the Pros and Cons of conversion in the form of a prospectus in simple terms for the benefit of members asked to vote on conversion. The above recommendation transcends the superficial Blocked Disclosure currently recommended by NCUA in the call for comment. We believe that the more thorough recommendation, if implemented, would more consistently ensure the protection of members' *pro-rata* shares of retained earnings and avoid unjust enrichment by others to include officers and directors.

Respectfully submitted,

Ralph E. Reardon
SVP/Chief Financial Officer

⁸ Coastal Federal Credit Union