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Mutuals: A Capital Conundrum

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AUTHORED ARTICLE | Summer 2014

The Bankers' Statement – Summer 2014

Published in the Summer 2014 issue of *The Bankers' Statement*

Life as a mutual thrift is a good news/bad news proposition.

The "good news" is that you're not constantly facing shareholder pressures for performance and returns because you don't have shareholders to worry about.

The "bad news" is that your only current direct option for raising capital, when needed or desired, is severely restricted to the long-term mechanism of accumulating retained earnings.

Many, if not most mutuals, are smaller community-based institutions that are critical in retaining access to credit and banking services in small communities. There are nearly 600 mutual banking institutions in the United States, and a very large number are headquartered in Ohio. Most well-run mutuals have historically carried very high capital ratios because of their business model and inability to tap capital markets like stock companies. As a result, the limited source of capital does not enable them to maximize efficient use of capital because the sole replacement source is that of retained earnings. Thus strategic capital planning and opportunities for efficient use of capital are particularly problematic for mutual institutions.

Over the years, lawyers, accountants and regulators have concocted a number of complicated remedies intended to address the mutual "capital conundrum," including formation of fairly complex mutual holding companies and conversion mechanisms, all of which are time consuming, costly, entail complex tax ramifications and typically result in some loss of the advantages enjoyed by "standard" mutual organizations.

Other proposed mechanisms for raising capital (or "quasi-capital") have included exploration of the opportunity for development of subordinated debt instruments, which would qualify as "capital" for accounting and regulatory purposes.

Mutuals are unique entities. Customers become "members" with an interest in the institution that looks somewhat like a "shareholder" interest for election of directors and certain other matters while, in fact, they have no equity at stake. However customer members can in fact realize some "value" in a conversion or restructuring in the form of shares in the new entity that reflect their deposit and/or loan relationship with the mutual. Sometimes this leads to misunderstandings and misperceptions of the true nature of mutual "ownership" by members.

Following on the heels of the financial challenges starting in 2008, and the new pressures of Basel III, a number of new proposed "fixes" have been proposed, formally and informally, to enable mutuals to raise capital directly in the market to address both actual capital shortfalls as well as acquisition and other expansion opportunities.

One such proposal is H.R. 4252: the "Mutual Bank Choice & Continuity Act of 2014" (the Act). Introduced in early 2014 and referred to the House Financial Services Committee where it presently resides, the Act would provide, among other things, for:

1. the ability of mutuals to issue "Mutual Capital Certificates" (the Certificates) as unsecured subordinated investment instruments (similar to preferred stock), which would qualify as Tier 1 common equity; and
2. establishment of a "Mutual Bank Charter" to enable national banks to form as mutual organizations or to convert from a stock structure to a mutual structure. Such mutual national banks would not be restricted to the asset limitations of the HOLA for QTL status, but would enjoy the powers of a national bank with a mutual governance structure. Access to expanded opportunities for lending would enhance revenue opportunities for "mutual banks" while providing some of the advantages of the mutual charter.

The Act would also help to clarify mutual member rights and obligations, as well as the proxy process for mutual organizations. Mutuals desiring to retain their present structure and asset mix would be able to do so.

The American Bankers Association has endorsed the Act and the additional flexibility it would provide to mutual institutions.

States, such as Ohio, may consider following suit in order to assure charter competitiveness with their federal counterparts. Ohio has a significant number of state-chartered mutual institutions compared with other states, and the issues and capital challenges for state-chartered mutual institutions are the same as those for federally chartered mutuals.

Providing options for mutuals, whether state or federal, to raise capital without adversely impacting the advantages of the mutual charter can help strengthen the banking system and avoid consolidations, which result in reduced competition and availability of credit in some markets. With increased compliance and other costs, and reduced margins, mutuals (like stock institutions) are facing increasing challenges for survival. Limiting their ability to raise capital when capital is available only serves to increase the likelihood that fewer will survive and that communities, and the market, will be adversely impacted as a result. According to a recent *American Banker* article, a number of large mutuals with mutual holding company structures are actively considering potential full second-step conversions to stock organizations.

Enabling mutuals to increase their ability to survive and compete in the market, and provide needed credit to communities, can only add to the strength of the financial services industry.

What happens with the Act, and the prospect for similar state actions, remains to be seen.