Mutual-to-Stock Conversions by New England Savings Banks: Where Has All the Money Gone?

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In the aftermath of the real estate slump and the attendant financial troubles of the New England banks, it is natural to look for causes and contributing factors. One phenomenon that has received its share of the blame is the rush of conversions by thrifts in the mid 1980s from mutual to stock form of ownership.

Conversions were hailed initially as a way to fortify the eroded capital of thrifts and increase their safety and soundness. At the same time, conversions coincided with deregulation and the granting of new lending powers to thrifts. Foremost among these was the authority to make commercial and industrial loans, commercial real estate loans, and construction loans. A number of converted thrifts hastily invested their capital in real estate projects, many of them ill-conceived.

This article compares the behavior of converted thrifts with that of the mutuals. It finds that converted institutions took greater risks, suffered bigger losses, and failed at a higher rate than the mutuals despite being very highly capitalized after conversion. Three conclusions are reached. First, converted thrifts accounted for a substantial share of the increase in real estate financing during the boom of the mid 1980s. Second, ability to take greater risk, rather than efficiency, appears to have been a dominant motive for thrift conversions in New England. And third, even very high capital ratios may not prove sufficient if an institution takes big risks in its loan portfolio.

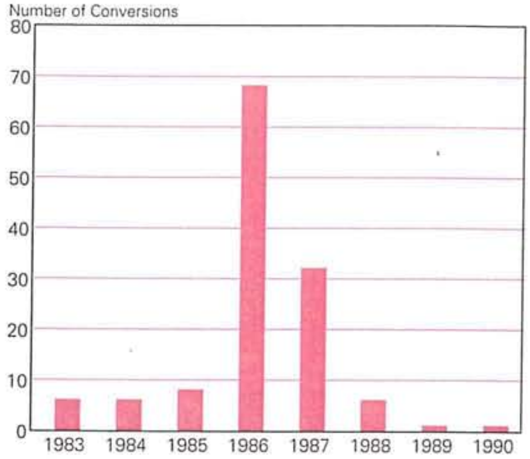
Part I of this article provides an overview of the mutual to stock conversion process. Part II describes the sample of thrifts under analysis and presents the empirical results. Part III analyzes management incentives. Part IV concludes with the implications for regulatory reforms.

I. The Conversion Process

Mutual thrifts are owned by their depositors. A conversion involves an issuance of stock to the public, which changes ownership from depositors to equity holders. (See Dunham (1985) for a historical overview and a step-by-step description of the conversion process.) Theoretically, depositors own the accumulated retained earnings of the mutual thrifts. To protect their ownership rights during conversion, the depositors are given nontransferable rights of first refusal to buy shares during the stock offering. They can buy stock in proportion to the size of their deposits (as of 90 days before the conversion plan is adopted by the thrift), as long as each depositor's share does not exceed 5 percent of the total offering. Management and directors who have deposits at the thrift can buy stock along with other depositors, subject to somewhat more stringent limits on their aggregate purchases. If any stock is left unsubscribed it is offered to managers and employees and marketed to the local community. Large stock offerings are sold by underwriters to the general public. The conversion process is completed only when all the shares are sold.

Figure 1

Conversions from Mutual to Stock Ownership among Thrift Institutions in the First Federal District



Source: Federal Reserve Bank of Boston Financial Institutions Tracking System; Board of Governors of the Federal Reserve System.

Reason for Conversion

Economic efficiency is often suggested as a reason for conversion (Masulis 1987; Mester 1991). Since the separation of ownership from control is greater in the mutual than in the stock form of organization, managers of mutual thrifts are more likely to pursue their own goals at the expense of depositors. Masulis suggests that managers of mutual thrifts will choose less profitable but lower-risk investment projects over more profitable but riskier investments. If mutual thrifts are subject to greater organizational inefficiency than stock thrifts, then conversion to stock form will improve efficiency, by aligning managerial incentives more closely with those of the stockholders. This will lead converted thrifts to invest in more profitable but riskier projects.

II. Performance of Converted Thrifts in New England

In New England, the majority of thrift conversions from the mutual to the stock form occurred since 1983. Of the 468 New England savings institutions included in the Federal Reserve Bank of Boston Financial Institutions Tracking System (FITS) in January 1983, only 12 had already converted. In contrast, 128 institutions have converted since that date. The pace of conversions accelerated in 1986 when low interest rates increased the thrifts' net interest margins, improving their profitability. This, together with the signing of the New England regional interstate banking pact, made the stock market very bullish on New England thrifts, which were considered prime takeover candidates for commercial banks. As can be seen from Figure 1, 68 thrifts converted in 1986 and 32 in 1987. However, the stock market crash of October 1987 effectively put an end to the conversion boom. As a result, only eight conversions occurred in the three following years.

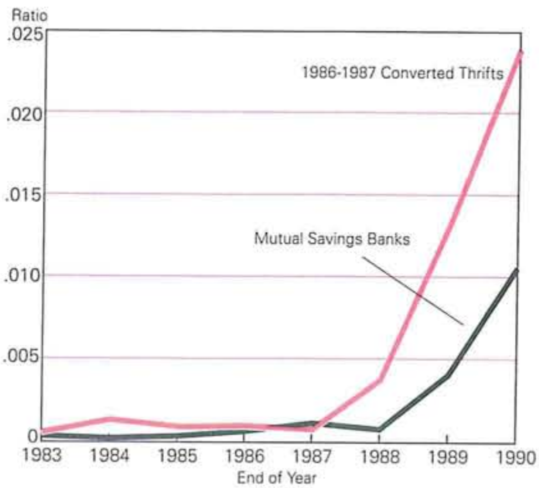
The substantial infusion of new equity capital that results from conversion could be expected to reduce the probability of insolvency by providing a cushion against failure. This did not happen in New England, where converted thrifts quickly loaned out the capital they raised and then proceeded to fail at an even higher rate than the mutuals. Of the 468 thrifts in existence in 1983, a total of 28 have since failed. (Failures include government-assisted acquisitions.) Of these, 13 were mutuals (4 percent of the total number of mutuals), while 15 were stock (11 percent of the stock thrifts). While the loans made by converted thrifts were indeed riskier than those made by mutuals, they were not more profitable. When the New England economy suffered a downturn, especially in real estate, converted thrifts sustained significantly higher losses.

The Sample and Data

The sample for this study consisted of New England savings banks that were in existence in 1983 and for which call report data were available. Savings and loan institutions (S&Ls) were not included, because they report on a different form and their balance sheet data are not directly comparable to those of the savings banks. Figure 2 compares the converted thrifts and the mutual savings banks in terms of their rate of loan losses from 1983 to 1990. The figure shows the end-of-year ratio of net charge-offs to total loans for those thrifts that converted in 1986 and 1987 and for the mutuals. These two years were chosen because they have the largest number of savings bank conversions in the sample (55). Since thrifts that convert tend to be bigger than mutuals, the comparison excludes all savings banks with less than $100 million in assets. However, including smaller banks does not change the results.

Figure 2

Ratio of Net Charge-Offs to Total Loans, in First District Mutual Savings Banks and Converted Thrifts[a]



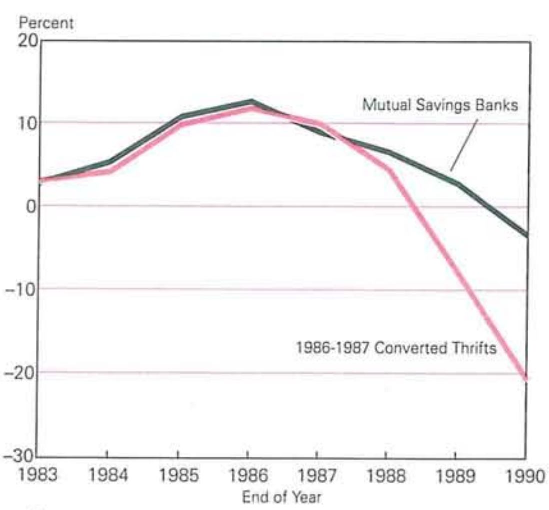
[a]1986-1987 converted thrifts and mutuals with more than $100 million in total assets.
Source: Board of Governors of the Federal Reserve System, Call Report Data.

While the New England economy was booming in the mid 1980s, loan losses were negligible for both mutual and converted institutions. During the subsequent downturn of the regional economy, all institutions suffered increased loan losses, but the converted thrifts incurred them earlier and at significantly higher rates. The figure shows they had higher losses in 1988, while the mutuals did not incur them until 1989. By 1990, the gap widened further. The average loss for the mutuals in 1990 was 0.8 percent of loans, while for the converted thrifts, it was 2.1 percent of loans. Testing for the equality of means, this difference in means was significant at greater than the 1 percent confidence level (Appendix Table A-1).

The high rate of loan losses evidently was not offset by high returns elsewhere. As a result of these losses, both mutuals and converted thrifts suffered declines in profitability. Figure 3 compares the return

Figure 3

Return on Assets for First District Mutual Savings Banks and Converted Thrifts[a]



[a]1986-1987 converted thrifts and mutuals with more than $100 million in total assets.
Source: Board of Governors of the the Federal Reserve System, Call Report Data.

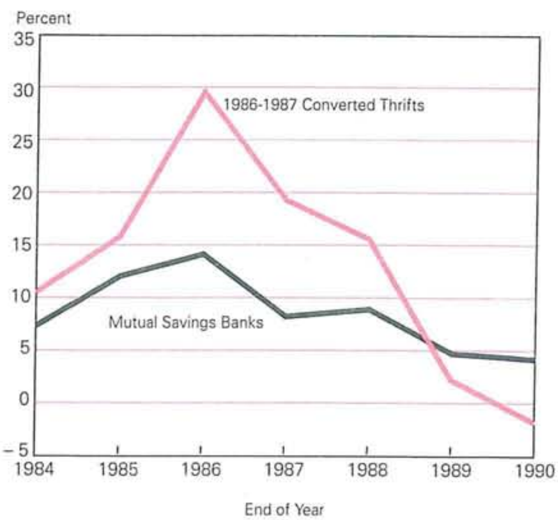
on assets (ROA) from 1983 to 1990 for the same set of institutions as in Figure 2. ROA follows the same pattern as loan losses—converted savings banks suffer losses earlier and at a significantly steeper rate than the mutuals (Appendix Table A-1). ROA turned negative for the converted banks in 1989, and while it also became negative for the mutuals in 1990, the average loss in that year was much larger for the converted banks in the sample.

Before they incurred their losses, converted institutions grew at unusually high rates, driven by the need to earn an adequate rate of return for their new stockholders. As Figure 4 shows, their rate of growth of assets was much higher than that of mutuals, reaching 30 percent at its peak in 1986. To achieve this high rate of growth, converted institutions assumed higher risk in both their assets and their liabilities.

Converted thrifts relied on federal funds (funds borrowed overnight from other depository institutions) and brokered deposits to fund their asset growth. Figure 5 shows the ratio of such volatile liabilities to total assets at mutual and converted institutions. Here, the difference is striking. Mutual savings banks kept their volatile liabilities below 1 percent of assets throughout the period under study. For converted thrifts, however, volatile liabilities increased sharply following conversion, reaching a peak of 6.2 percent in 1988. Even though the converted thrifts had reduced their volatile liabilities by half by 1990 in response to financial problems, their ratios are still far higher than those of the mutuals.

Figure 4

Rate of Growth of Total Assets for First District Mutual Savings Banks and Converted Thrifts[a]



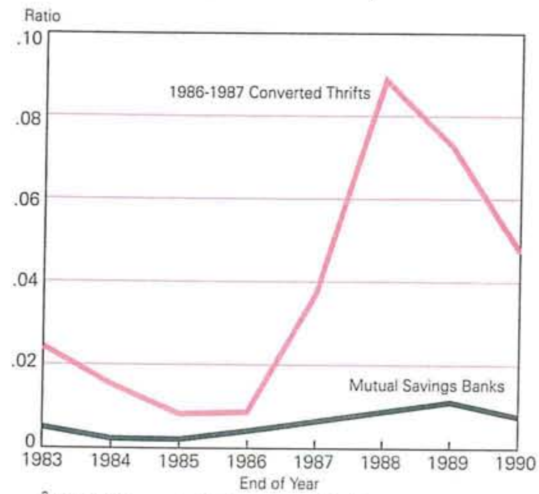
[a]1986-1987 converted thrifts and mutuals with more than $100 million in total assets.
Source: Board of Governors of the Federal Reserve System, Call Report Data.

Asset Composition

Converted thrifts grew by investing in riskier loans. Traditionally, the staple of the thrifts' loan portfolios has been home mortgages, the safest category of lending. In 1983, however, New England savings banks received the same investment powers as commercial banks. As a result, they began to expand into riskier types of lending such as business and commercial real estate.

Figure 5

Ratio of Volatile Liabilities to Total Assets in Portfolios of First District Mutual Savings Banks and Converted Thrifts[a]



[a]1986-1987 converted thrifts and mutuals with more than $100 million in total assets.
Source: Board of Governors of the Federal Reserve System, Call Report Data.

Table 1 compares the 1985 and the 1988 asset composition of mutuals, converted thrifts, and commercial banks of similar size (more than $100 million but less than $2.5 billion in assets). It is clear that, while differences in asset composition occur over

Table 1
Selected Assets as a Share of Total Assets, for First District Commercial Banks, Mutual Savings Banks, and Stock Savings Banks That Converted in 1986 and 1987
Percent

Asset	1985 Commercial[a]	1985 Mutuals[b]	1985 Converted[b]	1988 Commercial[a]	1988 Mutuals[b]	1988 Converted[b]
Total Loans	66.5	65.2	68.2	75.7	74.8	77.7
C&I Loans	19.0	3.7	4.8	18.2	5.1	7.4
Consumer Loans	15.5	6.8	6.5	14.2	5.3	4.0
Mortgage Loans						
1–4 Family	12.2	43.3	40.4	19.3	47.8	41.5
Multifamily	.9	3.0	2.8	.8	3.3	4.5
Nonfarm, Nonresidential	9.6	6.0	9.7	13.4	9.1	12.8
Construction	3.5	1.9	2.9	6.0	4.5	7.3
Equity/Assets	5.9	7.9	7.5	6.3	8.7	10.6
Loan Loss Reserves/Assets	.7	.2	.2	.8	.3	.5

[a]Commercial banks with more than $100 million but less than $2.5 billion in total assets.
[b]Mutual and stock thrifts with more than $100 million in total assets.
Source: Board of Governors of the Federal Reserve System, Call Reports.

time, converted thrifts still resemble mutual thrifts much more than they resemble commercial banks. Real estate lending remains the mainstay of all thrifts, and their percentages of commercial and industrial (C&I) loans and consumer loans are much lower than those of commercial banks. Within their real estate portfolios, converted thrifts concentrated on riskier categories of lending, increasing construction lending and multifamily mortgages. In 1988 they had a larger proportion of their assets in these categories than either mutual thrifts or commercial banks.

Figure 6 depicts the change through time in the proportion of commercial and industrial loans, construction loans, and nonfarm and nonresidential loans, respectively, in the savings banks' loan portfolios. All three categories showed a similar pattern—the converted thrifts had higher concentrations than the mutuals. An interesting point is that the converted thrifts' investment in risky categories was also higher than the mutuals' in years 1983 through 1985, that is, even *before* they converted. The difference became greater after the conversion, however. Evidently the managements of thrifts that converted showed a greater affinity for risk-taking, and this tendency was reinforced by the conversion.

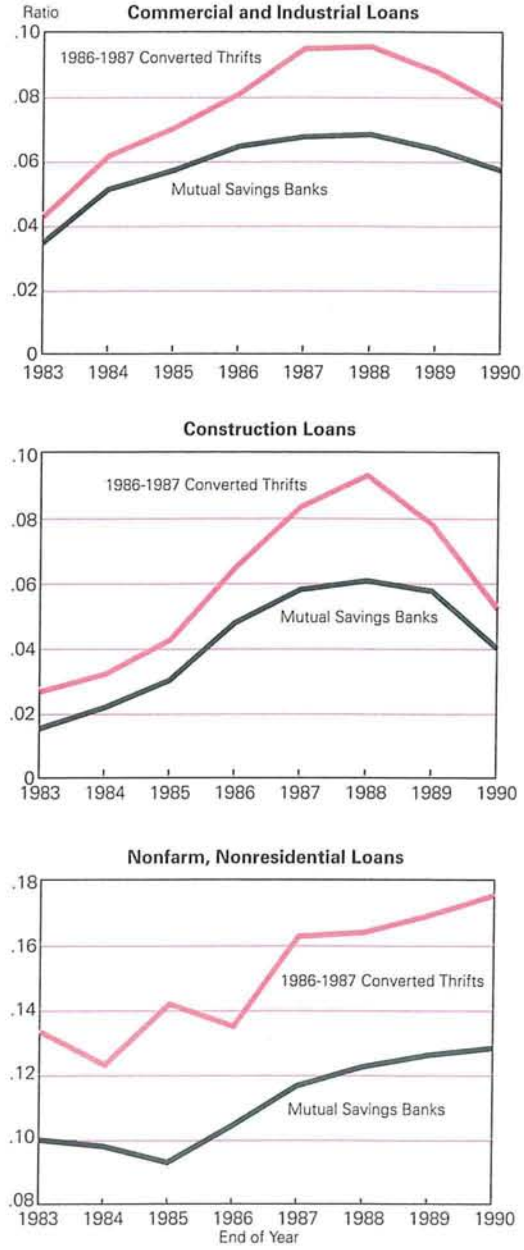
Converted thrifts also have a higher preference for liquidity risk than the mutuals. Figure 7 depicts the ratio of liquid assets (cash and marketable securities) to total assets at the mutual and converted savings banks. Since 1984, mutuals have held proportionately more liquid assets than converted banks. The proportion of liquid assets fluctuated at both sets of institutions, increasing from 1983 through 1985, then declining until 1989. In 1990, it increased again, representing a return to more conservative practices in reaction to the region's economic distress and financial difficulties.

Effect on the Real Estate Market

The rapid growth and aggressive lending practices of converted thrifts ensured that they accounted for a substantial share of bank assets and real estate lending in New England during the years of the real estate boom. In 1988, converted thrifts accounted for 17 percent of total assets of the FDIC-insured financial institutions in New England. They also accounted for 20 percent of all construction loans, 24 percent of nonresidential mortgages, and 41 percent of multifamily mortgages. These numbers somewhat overstate the importance of converted thrifts to the real estate market, since the totals reported here do not include the funds provided by non-New England banks and by life insurance companies, mortgage companies, pension funds, federal and state credit agencies, and other possible investors. Nevertheless, the contribution of converted thrifts is significant, especially in view of their share of the rapid growth of

Figure 6

Ratio of Selected Assets to Total Assets in Portfolios of First District Mutual Savings Banks and Converted Thrifts[a]



[a] 1986-1987 converted thrifts and mutuals with more than $100 million in total assets.
Source: Board of Governors of the Federal Reserve System, Call Report Data.

the real estate market in New England during the peak years of the boom.

Table 2 shows the increase in total assets, construction lending, and nonresidential and multifamily mortgages by all FDIC-insured financial institutions in New England, from 1986 to 1988. The table shows that converted thrifts accounted for 30 percent of the growth in total assets, 28 percent in construction loans, 32 percent in nonresidential mortgages, and 53 percent of the growth in multifamily mortgages.

As these numbers make clear, converted savings banks had a larger share of the flow than of the stock of real estate financing in New England. While the converted thrifts accounted for less than one-sixth of the total assets of the region's FDIC-insured institutions, they accounted for one-third to one-half of the flow of real-estate lending between 1986 and 1988.

III. Management Incentives

The above results demonstrate that converted thrifts took greater risks than mutuals and that their gambles resulted in greater losses as New England's economy deteriorated after 1989. It is clear in retrospect that these institutions did not employ their newly raised capital wisely and well. The benefit of hindsight is not necessary, however, to have foreseen the likely outcome of the sudden rush of conversions. The dangers were discussed in the press at the time and, presumably, were familiar to the managements and boards of directors of these thrifts. As early as 1986, for example, an article by Robert Eisenberg in *Banker & Tradesman* recounted the now-familiar litany of perils of commercial real estate lending, such as the susceptibility of the appraisal process to abuse, the difficulty of maintaining underwriting standards when loans are abundant, and the lack of experience among thrift managements in coping with the pitfalls of commercial real estate. The article even invoked the specter of empty Houston office buildings as a warning for New England, a comparison that was heard with increasing frequency later, as the New England real estate market collapsed.

Why did the thrift managements go through the conversions, given the evident dangers in the crowded marketplace? The answer lies at least in part in the personal fortunes that the managements hoped to make by acquiring stock as part of the conversion. On average, less than 5 percent of mutual thrift depositors exercise their rights to purchase stock

Table 2
Growth of Assets and Selected Loan Categories between 1986 and 1988 at FDIC-Insured Institutions, First Federal Reserve District
Billions

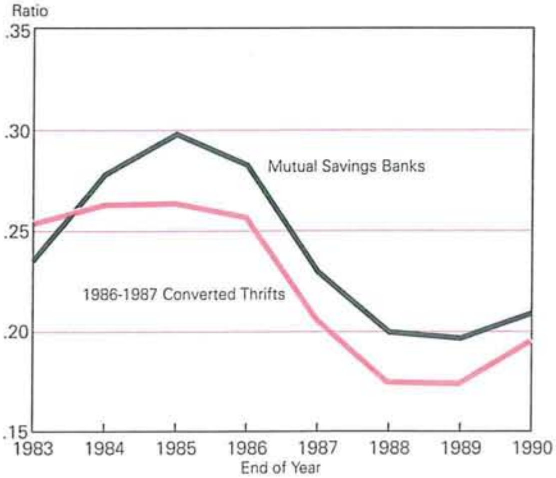
Institution	Total Assets	Construction Loans	Nonresidential Mortgages	Multifamily Mortgages
All Institutions	$63.4	$7.8	$10.9	$1.9
Converted Thrifts	$19.0	$2.2	$3.5	$1.0
Share of Growth by Converted Thrifts	30%	28%	32%	53%

Note: Converted thrifts include those that converted between January 1, 1983 and December 31, 1988.
Source: Board of Governors of the Federal Reserve System, Call Reports.

during a conversion, while management and directors purchased 20 percent of all conversion shares (Dunham 1985, p. 37). The price is determined by an independent appraiser who arrives at a "fair value" through study of comparable transactions and balance sheet analysis. The stock is then offered at a price within a range of 15 percent above and below the appraised value. The conversion price tends to be below market value, giving the management an immediate incentive to convert.

Figure 7

Ratio of Liquid Assets to Total Assets in Portfolios of First District Mutual Savings Banks and Converted Thrifts[a]



[a]1986-1987 converted thrifts and mutuals with more than $100 million in total assets.
Source: Board of Governors of the Federal Reserve System, Call Report Data.

The shares of converted thrifts are usually offered at a discount from their post-conversion book values. This occurs because pre-conversion net worth is distributed to the initial shareholders on a pro rata basis, since no founding shareholders exist to claim it. For example, suppose the stock is issued at $10 per share and pre-conversion net worth amounts to $5 per share. Then post-conversion book value is $15 per share, and the stock is said to be offered at 67 percent ($10/$15) of pro forma (post-conversion) book value. Accordingly, the share price can be expected to rise immediately in the secondary market, tempered only by the costs of conversion and the possible losses on the thrift's assets. This discount from the market value is in contrast to the typical takeover premiums for financial institutions. In a sample of 44 bank mergers completed in 1986, Adkisson and Fraser (1991) found merger premiums as measured by price/book ratio ranging from 1.00 to 2.60, with a median of 1.60.

Despite some unique regulatory requirements, the issuing of stock during thrift conversion is essentially equivalent to any initial public offering (IPO), and underpricing of IPOs is a well-known phenomenon extensively documented in the finance literature. (See, for example, Ibbotson, Sindelar, and Ritter 1988 for recent figures.) Various explanations for the underpricing have been advanced in the literature, from monopsony power of underwriters and insurance against legal liability to asymmetric information and incomplete markets (Loderer, Sheehan, and Kadlec 1991).

Evidence has shown that thrift stock prices do indeed exhibit large positive returns in secondary market trading following conversion. Masulis (1987) found a mean return of 5.6 percent on the first day and 11.4 percent in the first 20 days of secondary market trading in a sample of 78 conversions nationwide between 1976 and 1983. These numbers are all the more striking when one remembers that these are actual period returns and not annualized returns.

In New England, the thrifts that converted in 1986 saw impressive price gains in the stock market. Of 55 institutions tracked by Keefe, Bruyette & Woods Inc. that converted in 1986 and were still publicly traded in 1987, not one traded at a price lower than the conversion price on March 16, 1987, the date for which the Keefe, Bruyette & Woods data were published (McGurrin 1987). The gain in price from conversion to this date ranged from 14 to 130 percent, with an average gain of 62 percent. Although these gains demonstrate a clear means of personal enrichment for the thrifts' managements, conversion prices do not seem excessively low in view of the longer-term performance. For the 50 thrifts from the above 55 that were still traded on March 3, 1988 (again, the date for which prices were published), the average price gain had dwindled to 7 percent, and one-half of the banks were traded at a price lower than the conversion price (McGurrin 1988).

In addition, no evidence suggests that thrift managements anticipated the collapse in stock prices, took their profits, and bailed out. On the contrary, examination of insiders' share ownership as disclosed on proxy statements indicates that management and directors were more likely to increase than to decrease ownership of their institution's stock during 1987, regardless of the price change. As Table 3 shows, when the stock price fell after conversion, insiders sold stock in five institutions and bought it in 14. Chief executives alone, as opposed to all insiders, sold stock in one institution and bought stock in 14. From this indirect evidence, it appears that managements of converted thrifts suffered from excessive optimism and overconfidence, as did other New England thrift investors, and were not guilty of deliberate deception.

IV. Conclusion

Academic literature suggests improved efficiency as a result of reduced agency costs as the motive for conversion. This seems to be confirmed by the initial stock price increases of the converted thrifts. In retrospect, however, the desire to undertake riskier investments seems to have been the dominant motive for conversions. All managements of mutual thrifts had faced similar incentives before conversion, but it was those managements with an inclination for risk-taking that decided to convert.

The preference for risk among New England thrifts took the form of large investments in construction and multifamily mortgages. These institutions accounted for a substantial share of the increase in bank financing in these areas. As a result, they played an important part in the New England real estate boom.

The consequences of thrift conversions in New England sound a cautionary note for bank reform proposals that advocate increased capital requirements, especially in combination with reduced supervision of well-capitalized banks. Although this article presents no evidence on the effect of increased capital requirements on the portfolio risk of financial institutions, the fact that high capital ratios attained by thrifts upon conversion did not restrain their risk-taking is still significant. High capital ratios put pressure on managements to find investment projects with high payoffs, in order to provide adequate return to the new stockholders. Thus, increased capital levels alone should not be relied upon as a substitute for regulatory supervision.

Table 3
Changes in Insider Stock Ownership[a] of Converted Thrifts, Relative to Change in Stock Price[b]

	All Converted Thrifts[c]		Converted Thrifts with a Stock Price Decrease		Converted Thrifts with a Stock Price Increase	
Change	CEO	All Insiders	CEO	All Insiders	CEO	All Insiders
Increased Ownership	22	29	14	14	8	15
Decreased Ownership	4	8	1	5	3	3

[a]Ownership changes reported are for a yearly interval. usually from the end of 1986 or beginning of 1987 to the end of 1987 or beginning of 1988. The exact dates vary for each bank depending on the date of the proxy statement.
[b]Stock price changes are from the date of conversion to 12/31/87.
[c]New England thrifts that converted in 1986 or 1987 and for which proxy statements were available.
Source: Proxy statements.

Appendix Table A-1
T-tests of the Equality of Means: Mutuals and 1986–1987 Converted Thrifts in First Federal Reserve District

Net Charge-offs/Total Loans

	Mean		Standard Deviation				
	Converted	Mutuals	Converted	Mutuals	T-stat	D.F.	Prob >T
1988	.003303	.000604	.008130	.001143	2.4	56.1	.02
1989	.014060	.003740	.028553	.008047	2.6	58.1	.01
1990	.020738	.007892	.018130	.012111	4.7	73.8	.001

Return on Assets

	Mean		Standard Deviation				
	Converted	Mutuals	Converted	Mutuals	T-stat	D.F.	Prob >T
1988	.004731	.007005	.012383	.004247	1.3	61.7	.19
1989	−.010736	.003196	.034827	.009416	2.9	57.8	.005
1990	−.019638	−.001024	.024940	.011481	5.2	62.2	.0001

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