Understanding Mutuals in an Age of Uncertainty
Mutual banks have survived in the recent economic whirlwind but they face new uncertainty as skeptical new regulators set about to review their governance structure and insularity.

Are mutual savings banks, mutual savings and loans and mutual holding companies (mutual banks) a viable business model? The answer is yes when the board of directors manages the institution using best practices. The board must develop a strategic plan with input from management using the assistance of outside professionals. When so managed, mutual banks can develop a strong capital base to support a growing company, can serve their communities and be attractive to consumers.

However, it remains to be seen whether the Office of the Comptroller of the Currency (OCC) and the Board of Governors of the Federal Reserve (FRB) will view mutuals favorably. As of July 21, 2011, the Office of Thrift Supervision (OTS) was merged into the OCC, and the OCC assumed responsibility for the supervision of mutuals. Simultaneously, the FRB assumed the responsibility for the supervision of mutual holding companies to the extent such entities had previously fallen under the regulations of the OTS.
History of Mutuals Explains Unusual Ownership Structure

Mutual savings banks date back to 1816. Mutual savings banks were organized by wealthy, public spirited benefactors who contributed capital and served as trustees for institutions where small savers, mostly the working poor and lower classes, could safely deposit funds and earn interest. While the depositors technically owned the assets and earnings, the depositors did not have voting rights. State laws chartering mutual savings banks in various states reflected this concept. Between 1820 and 1910, the number of mutual savings banks grew from 10 to 637, while total deposits grew from $1 million to $3 billion. During the depression, with the advent of deposit insurance, mutual savings banks required professional management and mutual savings banks were provided with the option of a federal mutual charter in 1933, which provided members the right to vote, including for the election of directors. However, state chartered savings banks often provide a continuation of the historic organization in which the directors chose their successors. Mutual savings banks, while not originally chartered to facilitate home ownership, became a significant source of home mortgages following the depression.

Mutual building and loan associations date back to 1831 and were a precursor to the mutual savings and loans. These associations were created to facilitate home ownership through mutual membership. Today, with a few exceptions, only savings and loan associations survive. In these state charters, members were granted voting rights, including the right to elect directors. With the passage of the Home Owners Loan Act of 1933 (HOLA), a federal charter was created for mutual savings and loan associations. Mutual holding companies were a later development intended to assist both savings banks and savings and loans to expand.

While mutual savings banks differed from mutual savings and loan associations, including in voting rights, these institutions had one thing in common: The members owned the retained earnings and surplus, which constituted capital. However, this ownership was more theoretical than real because the only way to access the capital was to liquidate the mutual, at which point a liquidating dividend was sent to the depositors or members in existence at the time of liquidation. This entrapped capital was always an alluring treasurer to those who saw its worth.

While the entrapped capital was a buried treasure for investors, regulators had a much different view. For the safety and soundness supervisor, a nagging and difficult concern was how to deal with a mutual that needed capital. In the recent federal TARP program of 2008 and 2009, the U.S. Treasury and the banking regulators struggled to promulgate a form of capital assistance that might help mutuals. In the 2011 Small Business Lending Program from the U.S. Treasury, the same problem made government assistance virtually unavailable to mutual banks.

How a Mutual is Structured Today

Looking at mutual banks today, they often superficially look like their related brethren—stock banks. A mutual bank is supervised by a board of directors or a board of trustees, which is responsible for strategic oversight and appoints management to run the institution. The directors or trustees are elected annually each year, or the board may be classified with staggered terms, usually of three years. However, unlike a stock company, the directors or trustees are not elected by persons who have a financial stake in the organization. The board of a mutual bank may be elected by (i) its members (depositors and borrowers) who may have one vote each or a number of votes which is capped and related to the deposit amount, (ii) by its “incorporators” and their successors (a smaller group of depositors), or (iii) by the existing directors. However, even when the law requires that directors be elected by the depositor members, the members show little utilization of their voting rights because they have no economic incentive to do so. As a reflection of this fact, the state
statutes governing mutual banks, as well as the OCC model bylaws for mutual banks, provide that the quorum for an annual meeting to elect directors is a single member. In contrast, the quorum for a stock bank is 50 percent of the outstanding shares. Furthermore, the OTS approved by regulation the use of “running proxies” for federal and state mutuals. “Running proxies” authorize the board of directors of a mutual to solicit from members and to use a proxy which allows the board of directors to vote on behalf of the member and this proxy “runs” for as long as the depositor or borrower is a member. In contrast, the law with respect to stock banks limits the duration of proxies to no more than 11 months, subject to certain exceptions. Finally, unlike the statutes for stock corporations, which require that notice of the annual meeting of shareholders be mailed to all shareholders, the statutes governing mutual banks permit a notice of meeting to be posted in the bank offices and published in a local newspaper. Because it is unlikely to have the benefit of bringing mutual members out to vote, the law does not impose upon the mutual bank the cost of a full mailing.

The small quorum requirement, the failure to require that notice and the allowance of evergreen running proxies all reflect the fact that members have shown little interest in participating in mutual elections. The historically low voting at annual meetings of mutuals is unlikely to change, unless the mutual is forced to engage in expensive and continuous proxy solicitation and then it is unlikely to change significantly since members have no financial stake in the mutual. The members probably would view such a solicitation as unnecessary and intrusive. In conversions of mutuals to stock form, regulatory authorities require a majority vote of members, require a mailing to members and prohibit the use of running proxies. In conversion votes, even when the members possess a potential economic stake, expensive and intensive proxy solicitations are required to reach the majority vote level required.

**Negative Consequences**

Professional investors encourage conversions of mutuals to stock form. In one instance, a professional investor has sought to nominate his cronies to the board of a mutual to force a conversion and the mutual has been involved in years of litigation as a result. Professional investors become depositors of mutuals to take advantage of the potential profit to be made in a conversion. In a conversion, the capital of the mutual is transferred to a new successor stock entity, without cost to the new owners. While stock is sold for $10 a share, the new shareholders receive the benefit of the existing capital for free. In the early 1990s the median price increase on the first day of trading in shares of a converting mutual was 25 percent to 30 percent; in other words the professional investor could look forward to a 25 percent increase in his or her investment in one day. The OTS took steps to avoid this excessive first day “pop” by requiring additional appraisals that necessitated the sale of larger dollar volumes of new shares, thus diluting further the benefit of the existing free capital. However, professional investors in mutuals remained a strong presence. The behavior of professional investors is often predatory and unethical, which has been documented in a series of Securities and Exchange Commission civil complaints and Department of Justice criminal complaints.

Professional investors first infiltrate the mutual by evading community residency requirements and/or fronting funds for “local members” and others to purchase shares. In either case, true local members suffer reduced allocations for new shares. The list of mutuals in which these actions were taken is numerous. Of course, if the “professional investors” are local, the action is not necessarily illegal or unethical, as long as they do not front funds for others.

The financial interest of local and out-of-state professional investors provides a strong incentive to seek a conversion of the institution to stock form. Consequently, professional investors favor a board of directors which is willing to convert the institution. In a conversion, the OCC rules allow the directors to reward themselves and management with stock in the converted mutual, subject to shareholder
approval. These stock awards provide directors and management with incentives to convert.

The number of mutual banks has been steadily decreasing. Most surviving mutuals are located in the Northeast, many in Massachusetts and New Jersey. One explanation for the steady decrease in mutuals is the conversion to stock form. A second reason is that it is impossible to create a new mutual, except by converting a credit union into a mutual bank.

A final reason is the failure of mutual banks. Between 1986 and 1994, 58 mutual savings banks failed, as well as an even larger number of mutual savings and loan associations. First, they failed as a result of the mismatch in the early 1980s between the high interest rates paid on savings accounts and the low interest rate earned on fixed-rate mortgages. Later in the 1980s and early 1990s, mutual banks failed because they used new investment and loan powers granted to them during the 1980s in an ill-conceived effort to increase profits.

Of course, the insularity also poses a risk for management of a mutual. Mutual banks receive little or no member input from members. When boards have reacted negatively to professional investors, courts have criticized directors for placing obstacles in the way of professional investors who are members and want input. Governance advocates see this as the worst of bad governance. However, having a reputation for “bad governance” does not necessarily result in poor financial performance. Harvard University has maintained the same form of insulated governance since 1650. The President and Fellows of Harvard College choose their successors with no other approval required. However, few would criticize Harvard’s performance over its more than 350-year history. Would Harvard be better off if the college graduates or the voters of Massachusetts had to approve the successors?

To be an enduring model, mutual management must guard against the pitfalls of its insularity. Without the required disclosures that public companies must make to their shareholders, management may reward itself for performance that is less than adequate and may not have the stimulus to adopt the best practices that are necessary for safety and soundness. The banking regulator, be that the OCC, the FRB, the FDIC or the state banking authorities, serves as an excellent counterweight. However, a well-run mutual must focus on professional management, best practices, high ethical standards and service to the community for which it was created. If that mantle is maintained, a mutual bank can be an ideal and successful form of institution.

The Benefits of a Mutual Organization
In the Great Recession a few years ago, the remaining mutuals performed far better than their stock brethren. For example, while many commercial banks and converted thrifts took big hits on trust preferred securities, the overwhelming majority of mutual institutions did not. Brokerage firm salesmen between 1998 and 2006 were just as aggressive in pedaling these 30-year-fixed and floating-rate, triple-A rated, high-yield instruments to mutual institutions. But mutuals almost universally did not bite. The reason was that mutuals, unlike stock institutions, were not concerned about being taken over if their returns fell behind those of the high fliers. Mutuals did not have to show rising stock prices, based upon constantly increasing earnings per share, to remain independent.

That is the biggest advantage of the mutual organization—the ability to focus on the long term because of the lack of a stock price. A mutual may be better able to resist unnecessary risks because of this long-term view.