



CUNA & Affiliates

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**WRITTEN TESTIMONY
OF
TOM R. DORETY, PRESIDENT & CEO
SUNCOAST SCHOOLS FEDERAL CREDIT UNION
ON BEHALF OF THE
CREDIT UNION NATIONAL ASSOCIATION
HEARING ON
H.R. 3206, CREDIT UNION CHARTER CHOICE ACT
BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS,
HOUSE COMMITTEE ON FINANCIAL SERVICES**

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Chairman Bachus, Ranking Member Sanders, and members of the Subcommittee, I am Tom Dorety, President and CEO of Suncoast Schools Federal Credit Union in Tampa, Florida. I also serve on the Board of Directors and as Treasurer of the Credit Union National Association (CUNA). I appreciate the opportunity to appear before the Subcommittee today on behalf of CUNA to address the issue of credit union conversions to mutual savings banks. CUNA is the largest credit union advocacy organization, representing over 90 percent of our nation's more than 8,800 federal and state chartered credit unions and their 88 million members.

Suncoast Federal Credit Union was chartered in 1934 as Hillsborough County Teachers Credit Union. Today it serves public and private school employees, students and county employees in 15 counties along the west coast of Florida. With over \$5 billion in assets and 400,000 members, Suncoast is the largest credit union in Florida and the seventh largest credit union in the United States as ranked by assets. The driving force behind Suncoast's growth and success is the same mission for which it was founded over 70 years ago: to improve the quality of our members' lives by maintaining a strong, secure and innovative credit union that builds trust, shows respect and maximizes efficiency.

I am honored to provide CUNA's position on a number of important issues relating to credit union conversions to mutual bank charters. I also want to respond to the inaccurate or misleading information Congress has received regarding these conversions and the role of the National Credit Union Administration (NCUA) in overseeing the conversion process. CUNA believes that the credit union charter currently provides the best vehicle for serving the financial needs of consumers. However, we also support the right of credit union members to exercise their full democratic control over the structure and operation of their credit union. Should, after full and balanced disclosure, credit union members decide to convert the credit union to a mutual savings bank, CUNA supports their legal right to do so, but strongly believes that the unique ownership interest of credit union members must be protected and that members be fully informed of what is at stake in a conversion.

Toward this end, CUNA believes that five important principles should govern all conversions of credit unions to mutual charters:

1. Credit union boards that are considering conversions should make their decisions based solely on the best interests of their members.
2. Credit union directors and managers have a fiduciary responsibility to present objective and honest information to members regarding conversion proposals as well as other reasonable business alternatives.
3. Full, plain language disclosures are essential to furthering the democratic process of deciding to approve or reject a conversion proposal.
4. Since the net worth of the credit union belongs to the members, there should be no unjust enrichment to directors and senior management upon conversion of a credit union to a mutual thrift or any subsequent conversion to a stock institution.
5. The NCUA and state regulators must make full use of their current authority to ensure that credit union members understand the conversion process and that fiduciary duties of credit union boards are fully enforced.

Key Differences Between Credit Unions and Mutual Thrifts

Conversion decisions are significant because they diminish and ultimately may extinguish credit union members' ownership rights in their institution. Mutual savings banks are not just credit unions by another name as some would have you believe. Credit unions are not-for-profit cooperatives, which are operated solely for the benefit of the member-owners---not for the benefit of stockholders, boards of directors, or for the institution itself. Credit unions operate without paying a dime to most of our boards of directors and without providing stock options to our senior management. We are able to do this because of the devoted efforts of tens of thousands of selfless volunteers for whom credit unions are not just a business, but a cause. Our guiding principle, "not for profit, but for service," clearly makes us unique among financial institutions.

Mutual savings banks, on the other hand, are for-profit businesses. When a credit union converts to a mutual charter, the character of the institution materially changes. There are significant ownership differences between credit unions and mutual thrifts that conversion advocates tend to obscure, and the process set up by the Office of Thrift Supervision (OTS) to review and approve conversions fails to take such differences into account.

Voting Rights: In a federal credit union, each member has one vote regardless of the amount of funds in his or her account, and proxy voting is not permitted. This differs from the voting rights of depositors of mutual savings banks in which proxy voting is

generally used and votes are routinely apportioned based on account balances. Unlike credit unions, depositors of a mutual savings bank do not control the institutions. As explained in OTS's 2003 *Regulatory Handbook*, "Except for provisions relating to the conversions of a federal mutual to stock form, there is no statutory requirement that federal mutual savings associations' members have voting rights."

Ownership Rights: Credit union members are not simply depositors of, or borrowers from the institution. They own the net worth of their credit union and have a vote in selecting their peers who will determine how the net worth can best be used to benefit the membership. This is not the case in mutual institutions, as OTS and the courts have stated. In a June 2002 opinion, the OTS Office of General Counsel clearly stated: "The federal courts have concluded that owners of federal mutual savings associations have only very limited equity interests in those institutions and those interest do not include any rights as owners..."

Personal Enrichment: As not-for-profit organizations, credit union directors and managers are prohibited from taking actions that benefit themselves at the expense of the broader credit union membership. Board directors also generally do not receive compensation, and the Federal Credit Union Act specifically prohibits directors and senior managers from receiving any economic benefit from a charter conversion. OTS rules for mutual savings banks, by contrast, permit considerable personal gain, both in terms of director compensation and eventual stock ownership. While imposing some restrictions on self-dealing by insiders in the conversion process, OTS permits considerable stock ownership by directors and management when mutuals convert to partial or full stock ownership.

Economic Benefits of Credit Union Membership

Whether credit union members relinquish significant rights and economic benefits when their institution converts to a mutual savings bank is a central question in considering the appropriateness of such conversions. CUNA believes that credit union members enjoy substantial benefits as a result of doing business with a credit union which are both tangible and intangible. On the intangible side is the sense of belonging and control that many members enjoy with a credit union. This is reflected in the high customer satisfaction ratings members give their credit unions. The *American Banker* survey of customer satisfaction with financial providers published in June 2005 gave credit unions the highest rating of all financial institutions, while a number of banks were rated unfavorably, and no mutual savings bank was even noted. Similar surveys published over the prior eighteen years also gave credit unions consistently higher member/ customer satisfaction scores than both banks and thrifts.

A number of factors combine to create tangible economic benefits for credit union members. These include the absence of having to pay stock dividends to stockholders, the effect of tax exemption, and the near absence of directors' fees. These factors help to produce higher returns on shares, lower interest rates on loans, and lower service fees

than comparable bank products. CUNA's Research and Policy staff estimates saving for credit union members of over \$6 billion in 2002, or roughly \$160 per year per member household.¹ Credit unions also help to moderate bank fees and interest charges for all consumers.

No economic analysis has been presented that can demonstrate that any mutual conversion has advanced the ownership rights or economic benefits of credit union members. On the contrary, several recent studies show that both member rights and economic benefits may be substantially reduced following conversion to a stock institution. For example:

- A cross-sectional analysis of interest rates charged on loan and savings products by 175 banks, thrifts, credit unions and recently converted credit unions by University of Wisconsin-Whitewater researchers Heinrich and Kashian found that credit unions “offer significantly higher rates on savings accounts and lower rates on many loan products than do banking institutions.” The study found that the cost differential was “especially notable” when comparing interest rates between credit unions and former credit union/mutual banks and that the financial benefits of not-for-profit credit unions “either disappear or are much diminished when those institutions convert to banking institutions.”²
- In a broad study of credit union conversions, including a review of the 17 credit unions that converted to mutual savings banks and subsequently to stock institutions between 1995 and 2002, Professor James Wilcox of the University of California analyzed the effects of such conversions on member interests. First, he found that only those members who exercise their subscription rights and purchase stock protect themselves from losing their share of the credit union's net worth. He points out that “Historically, only a relatively small percent of members purchase share of stock via the subscription offerings.” As a result, the net worth of the credit union is redistributed to “well-informed insiders” and outside investors. His analysis goes on to conclude that even if all members were to buy their *pro rata* share of stock, they still might have been better off without a conversion depending on the credit union's initial net worth ratio, and how advantageous the credit union's loan and saving pricing was relative to stock-owned alternatives.³

¹ “The Benefits of Credit Union Membership”, CUNA Research and Policy Department, at http://advice.cuna.org/econ/member/download/whpaper_mmrshp.pdf

² Heinrich, Jeff and Russ Kashian (February 2006). “Credit Union to Mutual Conversion: Do Rates Diverge?”. Fiscal and Economic Research Center, University of Wisconsin-Whitewater.

³ Wilcox, James (January 2006) “Credit Union Conversions to Banks: Facts, Incentives, Issues, and Reforms.” Haas School of Business, University of California at Berkeley.

- A government report on conversions of British non-profit mutual building societies and life assurance companies to stock companies between 1995 and 2000 found that the remaining mutuals outperformed their converted rivals in a variety of financial performance indicators and passed along these cost advantages to consumers in terms of better rates. The study also found “there had been substantial increases in remuneration enjoyed by directors of those institutions which had demutualized...but no corresponding improvement in performance.”⁴ In part due to the experience of these conversions, Britain has issued rules prohibiting conversions of credit unions to banks.

Need for Greater Transparency in Mutual Conversions

The conversion of a credit union to a mutual savings bank involves a complex legal process in which the credit union ceases to exist and changes into another form of financial institution with different, and lesser, democratic control and ownership rights. As the size of the converting credit unions has increased, the issues involved have become even more complex and controversial. Because the fundamental nature of the institution is changed and ownership rights and benefits are at risk, it is imperative that members be given timely, objective and balanced disclosures about a proposed conversion well in advance of any conversion vote.

The experience of recent conversions in Michigan and Washington illustrate that when credit union members have sufficient information to understand that a proposed conversion may not be in their best interest, they will take action to block or oppose it.

Congress has assigned to NCUA a number of key oversight responsibilities regarding credit union conversions. NCUA has been directed to write and implement regulations governing conversions. The agency also administers membership votes and sets standards for membership communications and disclosures that must be met by converting credit unions. The Federal Credit Union Act and NCUA rules require converting credit unions to provide written notices to members three months, two months and one month prior to any conversion vote. NCUA expanded its rules governing the disclosures in these notices in 2004, and again in 2005, to address the key questions of whether, and the extent to which, credit union members understand their ownership interests, and whether they understand and fully appreciate how these interests could be changed by conversion to a mutual bank and any subsequent conversions to a stock institution. These additional disclosures, with specific information required to be prominently featured, were designed to make disclosure more meaningful, not more burdensome, and to prevent important or needed information from being lost in small print.

While recent rule changes have improved the overall transparency of the conversion process, CUNA believes additional measures are needed to enhance the

⁴ The All-Party Parliamentary Group for Building Societies and Financial Mutuals (March 2006) “Windfalls or Shortfalls? The True Cost of Demutualization.” ACCA, London.

ability of members to fully understand and participate in all aspects of the conversion debate. In particular, CUNA urges NCUA to consider possible rule changes to:

- Require that all disclosures be given in plain language that can be easily read and understood by credit union members.
- Clarify the fiduciary obligation of credit union directors and managers to present factual and objective information to document how a proposed conversion would serve the best interests of members.
- Provide for a public comment period on conversion proposals in advance of the distribution of ballots to members.
- Establish a process or mechanism for members opposing a conversion proposal to communicate with the full credit union membership.

The Credit Union Charter Choice Act

CUNA wishes to go on record as strongly opposing H.R. 3206, the “Credit Union Charter Choice Act,” as introduced by Representative McHenry. We believe he, too, wants to improve the conversion process. However, rather than improving the process of providing members with sufficient information to make an intelligent decision regarding a proposed conversion, H.R. 3206 would imprudently erode NCUA’s authority to make sure that credit union members facing a conversion vote have sufficient information to make informed decisions. As a result, no regulator would have sufficient authority to protect members’ interests. Particularly harmful, from the credit union perspective, are changes in H.R. 3206 that would:

- Eliminate any prior review by the NCUA Board of proposals to convert a credit union to a mutual charter and limit the Board’s oversight only to review of the written notice, ballot and related materials to be mailed to members regarding the conversion vote.
- Eliminate important disclosures in the written notice to members relating to possible subsequent conversions to a stock institution and the potential impact on members’ ownership and voting rights.
- Prohibit the NCUA Board from any action to regulate the content of any other communication relating to the conversion, except to prevent communications from including inaccurate material facts that are “knowingly false or misleading.”
- Strip NCUA of any role in overseeing the conversion vote, other than to certify the voting results transmitted by the independent inspector to the OTS within 10 calendar days of the vote.

- Prohibit NCUA from requiring a new member vote in response to improper notice or voting procedures, except where it can show that a notice contained a “knowingly false statement that affects the outcome of a conversion vote.”

In addition, while H.R. 3206 retains the current law prohibition against credit union directors or senior managers receiving any economic benefit in connection with a conversion to a mutual bank, it would prevent NCUA from having any authority over the conversion process once the member vote is certified. Given OTS’ record, this provision effectively nullifies any possible enforcement of this important protection against insider enrichment for credit union members.

Recommendations for Congressional Action

CUNA urges the Subcommittee to reject H.R. 3206 and, instead, take more proactive measures to address the underlying issues of credit union conversions. First, we urge Congress to adopt measures to address the key problems that have prompted credit unions to seek mutual bank charters, including the need for more flexible capital requirements less stringent limits on investment, and more flexible small business and real estate lending authority. Proposals that address these problems are currently pending before this Subcommittee as part of the Credit Union Regulatory Improvement Act (H.R. 2317), introduced last year by Representatives Royce and Kanjorski.

Second, Congress should address the gap in current regulatory authority by directing the Office of Thrift Supervision to enforce the current prohibition against credit union directors or senior managers receiving excessive compensation or other economic benefit in connection with the conversion of a credit union to a mutual charter.

Third, to minimize the potential for insider self-enrichment as a motive for credit union conversions, Congress should enact proposals, like that proposed in the past by former Chairman Leach, to restrict the ability of directors and managers involved in credit union conversions to obtain stock and other compensation in connection with any subsequent conversion to a partial or full stock institution.

Conclusion: The Reality of Insider Enrichment

Mr. Chairman, let me make a personal appeal to the Subcommittee to give careful consideration to the issue raised by my last recommendation: the potential for insider enrichment as a motive for credit union conversions. Of the 18 credit unions that converted to mutual savings banks between 1995 and 2004, 16 (89 percent) have undergone subsequent conversion to stock banks or partial stock mutual holding companies. One of two Texas credit unions that converted to mutual charters less than five months ago has already filed notice with the Securities and Exchange Commission of its intent to convert to a stock thrift, with 8 directors dividing at least \$1.7 million in stock in the initial stock offering.

I am not implying that all these conversions have been motivated by hopes of private gain. But with less than 20 percent of credit union members actually participating in most of these conversion votes, significant opportunity is created for insider directors and senior managers to enrich themselves in subsequent conversions at the expense of unwary or less informed credit union members. According to a survey published by *Credit Union Journal* in June, 2005, directors and managers have acquired voting control of nearly all former credit unions converting to stock institutions. Outside investors also stand to benefit at the expense of former credit union members with well-timed deposits in mutual thrifts in anticipation of stock purchases based on deposits. The April 2005 conversion of one mutual bank, a former credit union with \$400 million in assets before its initial conversion, attracted nearly \$100 million in additional deposits leading up to its initial stock offering.

The ability of insiders to “game” these conversions for their own financial benefit is frequently emphasized by the consultants who have handled most of the recent credit union conversions. I have been informed by these consultants that Suncoast could raise \$850 million in a stock conversion if it converted to a bank, and that I personally could expect to receive \$35 million after five years, assuming stock purchases and compensation plans common to recent conversions.

Its one thing to start a public company, invest your own money and realize whatever gain is possible from its sale. Its another thing, however, to use capital that belongs to all members of a credit union, that has been acquired over decades of hard work by volunteer boards and the benefit of federal tax exemption, to enrich a select group of individuals who do little more than engineer the conversion of the credit union to a bank. Not only is this bad public policy, it is anti-consumer, anti-taxpayer, and just plain wrong.

In conclusion, we appreciate the opportunity to appear here today on the very important issue. I hope my statement has helped shed light on the real concerns involved with conversions. I look forward to your questions. Thank you.