AMERICA'S MUTUAL BANKS
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Mutual Alert

OCC Issues Long Awaited Mutual Bulletin Citing "Unique Distinctions" in Compensation, Earnings and Capital

Working with the various mutual institution executives that sit on the OCCs Mutual Savings Association Advisory Committee, the OCC released a long awaited Bulletin on the special characteristics of mutuals as a reference guide. You may recall that AMB sent a letter to the MSAAC seeking clarification on compensation some weeks ago a copy of which is attached.

The Bulletin is designed to be a guidance regarding the differences between federal stock and mutual associations. It acknowledges the obvious structural and corporate governance differences but expands upon those difference by discussing the operation distinctions.

The Bulletin highlights the "important operational considerations in assessing risks at mutual for each of the CAMELS components" This is a welcome release for those mutuals that have enjoyed high capital but because of regulatory burdens and the need to maintain administrative efficiency have produced less earnings than lower capitalized stock companies.

The operational areas discussed by the Bulletin and a brief description of that discussion are:

CAPITAL ADEQUACY
The Bulletin discusses retained earnings as the only practical source of capital for mutual. It acknowledges the traditional alternative forms of mutual capital such as pledged deposits, non-withdrawable accounts and mutual capital certificates "MCCs". It suggests that there would be difficulty employing these historical alternatives today but significantly understates the practical impossibility of utilizing them as tier 1 capital under the Basel III regulatory scheme. It is notable that the OCC characterizes MCCs as "long term debt" when to our knowledge they have historically been characterized the same as preferred stock as permanent equity. Such a characterization does not bode well for the OCC view as to proposals to legislate MCCs as tier 1 capital.

Conversion to Stock

What appears to be a suggestion to examiners and Board members that a mutual can raise capital by conversion to stock is addressed in two paragraphs covering full conversions and MHC conversions. Evidently, the OCC sees a conversion as a capital alternative for mutuals rather than an abandonment of the mutual form. While a mutual has the ability to raise capital by relinquishing its mutual charter few if any troubled mutuals could convert to stock to raise capital without exposing their depositors to inordinate risk. What is concerning about this discussion is that the OCC seems to believe that conversion is the capital raising action of last resort rather than creating capital raising alternatives for mutuals before they become troubled. Ironically, it is the highly capitalized mutual that is the typical conversion candidate.

Asset Quality

The Bulletin acknowledges that mutuals usually hold higher ratios of assets in residential loans than stock federals and tend to originate for portfolio. Importantly, the Bulletin acknowledges that mutuals tend to have higher capital to mitigate against the risk of residential portfolios.

Management

The Guidance emphasizes that strategic, capital and succession planning are important for mutuals in the context of weighing management.

Compensation

As a response to the comments by AMB and our individual members, The Bulletin acknowledges that mutuals may use a " combination of "higher salaries bonuses and benefits to overcome" the disadvantages of not having stock based compensation to attract and retain talent. It acknowledges phantom stock plans as an acceptable device subject to reasonableness. Overall mutuals should be prepared to compare total comp with stock company total comp.

Earnings

Most significantly the Bulletin recognizes that mutuals have lower earnings than stock companies but enjoy higher capital ratios. It cites lower earnings non-interest income, ROE, NII, NIM as areas where mutuals may compare unfavorably with stock companies. However the guidance states that mutuals may have more stable, earnings and *that examiners should whenever possible compare them with other mutuals* to provide more meaningful trend line information. Indeed the Bulletin which provides a chart which directs examiners to back out dividends of stock companies when comparing profitability with mutuals seems to beg the question. Many mutuals have less profitability depending how you measure profitability because they have no need to accumulate earnings but pass them on to the community in the form of higher rates on deposits and lower rates on loans. Unfortunately , the OCC does not mention this fundamental difference.

Liquidity

This section says little other than mutuals typically rely less on wholesale funding of liquidity than Federal stock associations.

Conclusion

All in all the OCC is making a genuine effort to demonstrate its sensitivity to mutuals. Nonetheless the Bulletin reveals that there is still room for improvement. As Warren Buffett says "if you are batting a thousand you are playing in the minor leagues". You are encouraged to write the OCC to express your appreciation and suggestions particularly its failure to acknowledge the most fundamental characteristic of a mutual the commitment to return value to its members and community not earnings to its stockholders. Unlike a stock company that value can be transmitted a number of ways: service to the community through volunteerism, higher rates on deposits, lower rates on loans and direct contributions and a variety of other mechanisms other than earnings.