



116370

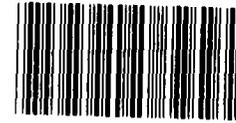
UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT
DIVISION

SEPTEMBER 18, 1981

B-202668

The Honorable Richard T. Pratt
Chairman, Federal Home Loan Bank
Board



116370

Dear Mr. Pratt:

Subject: The Federal Home Loan Bank Board Should Require
Organizers of Mutual Associations to Pledge
More Savings When the Association's Likelihood
for Success is Questionable (GGD-81-92)

We have recently completed a review of the Federal Home Loan Bank Board's (FHLBB's) examination and supervision functions. During our review, we became aware of supervision problems resulting from the chartering of mutual associations. This letter addresses the FHLBB's requirements for chartering mutual associations, the Office of Industry Development's (OID's) and the District banks' analyses of charter applications, and the Board's decision process for mutual association applications.

Our review showed that the Board:

- Frequently approved applications to organize mutual associations when there was disagreement between OID and the District bank about the associations' ability to succeed.
- Has not required new mutual associations to pledge savings higher than the minimum, although the supervisory agents recommended such action or disapproval of the application.

Mutual associations that are marginal performers can present substantial supervisory problems. Because of the present economic climate and the growing number of mutual associations in the FHLBB problem book, the FHLBB should require organizers to pledge more savings when OID and the District bank disagree on an association's likelihood for success.

(233065)

015575

BACKGROUND

Savings and loan associations may organize as State-chartered stock or mutual associations, or as federally chartered mutual associations. Each organization is subject to different laws and requirements. Stock and mutual associations differ in their capital structure. Stock associations issue permanent stock to shareholders in exchange for their investments. New mutual associations obtain their capital from net income earned from investments made with savings deposits, and ownership is vested in the depositors (members) of the association.

Associations applying for a Federal charter can organize as only mutual associations, although they may convert to stock associations later. Associations chartered by States can organize as mutual or, if State law permits, stock associations. As the table below illustrates, most of the 4,002 associations insured by the Federal Savings and Loan Insurance Corporation (FSLIC) are organized as mutuals.

Savings and loan associations

	<u>Operating as of December 31, 1980</u>
Federal mutual	1,946
State mutual	1,267
Federal stock	39
State stock	<u>750</u>
Total	<u><u>4,002</u></u>

The FHLBB must approve all Federal charters and all insurance of accounts by FSLIC (including State-chartered institutions applying for FSLIC insurance) and accordingly has established criteria for approving applications. FSLIC must reject insurance applications if it finds the capital is impaired because of various legal restrictions, such as liens upon the association, or if its financial policies or management are unsafe. It may also reject the application if it finds that the character of the applicant's management or its home financing policy is inconsistent with the purposes of the National Housing Act (12 U.S.C. 1725). 1/

1/This act established the FSLIC to ensure the stability of the savings and loan industry.

The FHLBB uses other criteria to rule on chartering Federal associations, including whether

- a necessity exists for the proposed association in the community to be served by it,
- the association has a reasonable probability of success, and
- it can be established without undue injury to properly conducted existing local thrift and home financing institutions.

The FHLBB has set minimum capital and pledged account requirements for applicants requesting insurance of accounts with FSLIC or permission to organize under a Federal charter. The capital requirements vary by the form of organization and the population of the area. In addition, the FHLBB has specified a minimum number of people from whom stock and savings must come at each population level.

Mutual applicants must pledge 20 percent of withdrawable savings 1/ or \$250,000, whichever is less, with the appropriate Federal Home Loan Bank (District bank) as a guarantee against operating deficits in excess of reserves. The minimum guidelines for capital requirements and pledged accounts were last set by the FHLBB in May 1976. Upon organizing, the applicants must sign a pledge and escrow agreement and turn over documents showing title to the accounts pledged. The pledged accounts provide some protection to the FSLIC fund should the association fail. The District bank retains the documents until the association meets Federal net worth requirements on any closing date following 5 years from the date of insurance. 2/

1/For withdrawable savings for an association in a population area less than 25,000, the smallest possible pledge would be \$100,000, or 20 percent of the \$500,000 requirement.

2/Until July 31, 1980, associations had to meet two requirements, the Federal insurance reserve and net worth. The FHLBB no longer requires the former.

OBJECTIVES, SCOPE, AND METHODOLOGY

We initiated this review to assess the FHLBB's decision-making process for chartering new mutual savings and loan associations. A second objective was to assess the FHLBB's minimum financial requirements for organizers of new mutual associations and the extent to which the financial requirements reflect the associations' potential for success.

We conducted the majority of our work at FHLBB headquarters in Washington, D.C., and the FHLBB's Office of Examinations and Supervision district offices in Little Rock, Arkansas, and Boston, Massachusetts. To the extent necessary, we interviewed officials from the FSLIC and the FHLBB's Office of District Banks and OID.

We reviewed 1978 and 1980 Federal charter applications and the digests, or analyses, prepared by OID and the appropriate District bank. Of the 16 Federal charter applications submitted in 1978, we reviewed all 9 for which complete FHLBB documentation was available. Five of the applications were from the Little Rock Bank and four were from the Atlanta Bank. These cases were selected in order to evaluate the performance of these associations since their applications were approved.

Of the 10 Federal charter applications submitted in 1980, we reviewed the 8 for which complete FHLBB documentation was available. Five of the applications were from the Little Rock Bank, two from the Atlanta Bank, and one from the San Francisco Bank. These cases were selected so we could assess the more recent FHLBB application review and decision process.

We determined the financial progress of the 73 mutual savings and loan associations which still had savings accounts pledged in escrow and which had been federally chartered since January 1, 1970. We calculated each association's net worth as of December 31, 1980. We defined net worth as assets minus liabilities as reported by the association to the FHLBB. We did not determine the financial progress of all mutual associations insured or chartered since January 1, 1970, because, for those which had failed, merged into other associations, or released their pledged accounts from escrow, we could not readily ascertain their original pledges from FHLBB records.

FHLBB FREQUENTLY CHARTERS ASSOCIATIONS
WHEN THE DISTRICT BANKS RECOMMEND DISAPPROVAL

The FHLBB rules on applications for new Federal charters based on information prepared by OID and the District banks. Organizers of new mutuels prepare applications and submit them to the bank in their district. The supervisory agent at the District bank analyzes the information, sometimes makes a visit to the proposed location, and prepares a digest. The digest for Federal charter applications provides basic information on the organizers, evaluates protests, and assesses the community or service area. The digest also analyzes the application against criteria for organizing or insuring and includes a recommendation of approval or denial.

OID prepares a memorandum to the Board which assesses the application and the District bank's digest. In the memorandum, OID makes a recommendation for action to the Board.

The supervisory agents and OID frequently differ in their recommendations regarding Federal charter applications. We reviewed 17 of 26 Federal charter applications submitted in 1978 and 1980, and found that OID and the supervisory agents differed in their recommendations to the FHLBB in 8 cases. In seven of the eight cases, the supervisory agent recommended disapproval and OID recommended approval. In all of these cases, the FHLBB ruled as OID recommended. In the other case, the supervisory agent recommended approval and OID recommended disapproval. This application was withdrawn prior to the Board's decision.

The supervisory agents and OID generally used the same facts in arriving at their conclusions, but they interpreted them differently. The supervisory agents, particularly from the Little Rock Bank, were less optimistic about the ability of some new mutual associations to succeed. For example:

--In a digest recommending denial for a new Federal charter, the supervisory agent recommended disapproval because (1) the need for a new association did not exist and (2) the probability of success was not strong. He wrote, "This proposed association must meet the challenges of the 1980's and compete with the established and experienced institutions. The association, a cripple at best, will not be strong enough to branch and offer a full line of services for many years." OID disagreed, stating that the savings increases experienced by other area associations demonstrated the potential drawing power of the area and the applicant's likelihood of success.

--In the digest for another application, the supervisory agent in 1978 commented that the association would have, "* * * less than a 50% chance of becoming a viable institution * * *." He based his conclusions on the poor operating records of new mutuals in high overhead markets, the fragmented market, and the location. OID concluded that these reasons offered no sound basis for denying the request, stating that the applicant's market area is very strong and OID believed it would be successful.

These cases illustrate the difference in philosophy between the supervisory agents and OID in reviewing applications. However, the FHLBB approved establishment of these mutual associations despite the supervisory agents' opinions that neither applicant met the criteria for chartering Federal associations. As will be discussed on page 9, several of the mutual associations which were chartered contrary to the supervisory agents' recommendations are experiencing serious financial difficulties.

PLEDGE REQUIREMENTS SHOULD REFLECT
FINANCIAL RISK OF NEW MUTUALS

Mutual savings and loan associations typically experience operating deficits during initial years. As a result of the present economic climate, profitability will be even more difficult. In some cases, initial deposits pledged by association directors to protect FSLIC have not been sufficient to cover the association's operating deficits. Regardless, no new mutual associations have been required to pledge savings over the minimum set by the FHLBB although the District bank suggested higher requirements in at least one case.

Difficult for mutuals to be
profitable during initial years

Mutual savings and loan associations by their organizational nature have no "free" capital to use for initial expenses. Capital for conducting initial business is obtained only from deposits--funds on which interest must be paid. Mutual associations have virtually no initial reserves and, consequently, no cushion for losses. Net worth, which would provide capital at no interest cost, must accumulate from profits. Building net worth in a mutual association is difficult, even in good economic times. In the present economic climate, the amassing of net worth is more difficult because savings and loan associations cannot attract funds easily due to low passbook interest rates and a weak demand for mortgages at the present high interest rates.

In 1978, FSLIC officials studied 65 associations that began operations in 1974 through 1978. They found that each type of association (State stock, State mutual, and Federal mutual) has the ability to attract savings capital, become profitable, and increase net worth. However, mutual forms do not initially perform as well as stock forms and are more risky.

Deficits have remained for longer than initial 2 years in several associations

The FHLBB requires the organizers of new mutual associations to pledge a specific amount of deposit accounts in escrow as a guarantee against net worth deficits. Evidence of these accounts, in the form of passbooks, savings or investment certificates, or other documents, is presented to and maintained by the District bank. Such accounts serve to protect the FSLIC fund in the case of an association's failure and should cover any initial deficits.

Several mutual associations have not attained a positive net worth position in their first 2 years of operation. We determined the December 31, 1980, net worth of all associations with pledged accounts. 1/ Of the 73 associations which were federally chartered since January 1, 1970, and which have accounts pledged in escrow, 25 had a net worth deficit on December 31, 1980. Fourteen of those 25 had been insured for more than 2 years.

Associations sometimes have net worth deficits that exceed their pledged savings. Of the 73 associations with pledged accounts in escrow as of December 31, 1980, we identified 5 associations with total assets of about \$69 million and total deficits 2/ in excess of \$1.2 million. These associations' net

1/The net worth figure used was assets minus liabilities, as reported by the association. In some associations, the directors maintain an account entitled, "Accounts Receivable from Directors" which consists of all deficits, thereby assuring a positive net worth balance for balance sheet purposes. Where we identified such instances, the balance of that account was subtracted from reported net worth to arrive at the operating net worth.

2/Net worth deficits used in this paragraph are those reported by the associations and may not agree with deficits calculated by the FHLBB.

worth deficits exceeded their pledged savings by about \$385,000. Two of the associations alone had combined deficits which exceeded their total original pledged accounts by about \$335,000.

No new associations required to
pledge more than minimum amount

The FHLBB has not required any organizing association to pledge more than the minimum initial escrow requirement. In one case, the supervisory agent at the District bank had recommended that the FHLBB require a larger amount. In this case, the FHLBB required the minimum amount of \$250,000 for a 100,000 or more population area but directed the association to develop a plan for obtaining additional pledges if necessary.

In addition to the cases where supervisory agents recommended requiring higher pledges, there were several cases where the FHLBB approved applications when the supervisory agents recommended disapproval. Frequently the basis for the supervisory agent's disapproval recommendation was that the association was unlikely to succeed, yet the FHLBB did not require a pledge higher than the minimum.

Two supervisory agents, one from each of the two districts that have the majority of new Federal associations, said they believe that the present minimum requirement for accounts pledged in escrow is too low in some cases. They stated that an association can accumulate a deficit of \$250,000 quickly in today's economic situation. One supervisory agent believes that pledged account requirements should be a minimum of \$500,000 and should be as high as \$1,000,000 if the association is in a fast-growing or highly competitive area.

MUTUAL ASSOCIATIONS CAN REQUIRE
EXTENSIVE SUPERVISORY ACTIONS

When associations have net worth deficits exceeding their pledged savings, supervisory agents generally require that the associations either pledge additional accounts in escrow to cover the amount of the deficit or merge with stronger associations. Some new mutuals, in an effort to protect the directors' pledged accounts, merge before severe financial problems occur. In some cases, FSLIC assistance is required. Overall, new mutual associations require extensive supervisory attention while struggling to become stable, and some will not survive.

Supervisory agents seek additional
pledges to cover net worth deficits

Mutual associations sometimes accumulate net worth deficits that exceed their original pledged savings accounts. The Office of Examinations and Supervision tries, through supervisory agents at District banks, to get additional pledged accounts from the directors to cover any deficits. Of the 73 associations with pledged accounts as of December 31, 1980, and insured or chartered since January 1, 1970, at least 11 have increased their pledged accounts from the original amount so that pledges would exceed deficits.

Supervisory agents contacted said obtaining additional pledges is usually not difficult. However, when directors are aware that they may not be able to save the association and might lose the pledges, it is more difficult to obtain additional pledges to cover the deficits. For example, one association in operation since the end of 1978 is now losing about \$40,000 a month. The organizers pledged \$150,000, but the deficit is roughly \$400,000. The burden on the directors to pledge that amount of additional money is too great, and additional pledges will not be sought. FSLIC plans to provide financial assistance and merge this association with another association.

Some mutuals expected to require
FSLIC assistance

Depositors of federally chartered and most State-chartered mutual associations are insured through the FSLIC fund. In protecting depositors, the FSLIC fund can be used to provide financial assistance to mutual associations which develop severe financial problems. Whenever FSLIC funds are used to assist an association, the association's pledged accounts are forfeited thereby increasing the association's net worth and reducing the amount of FSLIC assistance funds needed.

Three cases which FSLIC is anticipating will need financial assistance for rehabilitation are discussed below. In none of the cases will the pledged accounts cover the associations' net worth deficits, much less the expenditure anticipated by FSLIC.

--FSLIC is searching for a merger partner for a mutual association now operating with the FHLBB as conservator. Although the association reports a September 30, 1980, net worth deficit of less than \$125,000, the FHLBB contends the deficit is about \$740,000. Organizers of this association initially pledged savings of \$125,000 and later increased their pledge to about \$180,000.

An FSLIC official anticipates that some FSLIC funds will be required to attract a merger candidate.

--FSLIC has prepared a merger proposal for a mutual association operating since 1974. Its net worth deficit as of September 30, 1980, was about \$220,000, and pledged savings were only \$150,000. An FSLIC official estimated that the cost to FSLIC for a supervisory merger will be about \$800,000--\$500,000 in contributions and \$300,000 in lost opportunity costs on a \$4,000,000 loan to the association at an interest rate below the market rate.

--A third mutual association that was granted FSLIC insurance in 1973 is presently insolvent. As of September 30, 1980, its net worth deficit was \$188,000--its pledged savings of \$200,000 had already been forfeited. The association had originally pledged \$100,000. This association is expected to cost FSLIC about \$500,000 in contributions and \$250,000 in interest income foregone on below-market-rate loans to the association.

In each of the above cases, the associations were chartered by the Board over the recommendation of denial by the respective District banks. In addition, only the minimum in pledged savings was required.

Of the 73 associations which had pledged accounts as of December 31, 1980, 12 were on the FHLBB's problem list. Nine of the 12 have financial conditions which may require FSLIC assistance and financial outlays unless drastic changes can be brought about.

In comparison to older and larger troubled institutions, new mutual associations do not represent a potential major loss to FSLIC. However, an FSLIC official commented that the small, newer mutuals take as much or even more supervisory staff time than large associations.

Low net worth positions leave
mutual associations vulnerable

Many of the associations insured since 1970 are not in a deficit position but neither are they in the strong position of many older, established institutions. As discussed previously, mutual associations only obtain net worth from profits and may have a difficult time accumulating it. Because they start operations with no net worth and may have difficulty accumulating it, new mutual associations are vulnerable. One supervisory agent commented that the FHLBB has supported the idea of mutual

associations for a long time and takes the position that over time they will gain strength. During that time they will require extra monitoring.

CONCLUSIONS

New mutual savings and loan associations experience difficulty in obtaining profits during their initial years, especially during economic times like the present. Therefore, they require close monitoring, extra supervision, and possibly assistance with mergers. They also put FSLIC funds at additional risk, as some could require financial assistance to help them survive or to attract a merger candidate.

Because of the problems mutual associations can experience in attempting to become viable and financially strong institutions, the FHLBB should do everything within its power to charter and insure only those which have a good opportunity to succeed. Granting charters to mutual associations that do not succeed creates financial strain on the associations' organizers and possibly on the FSLIC fund. In addition, these associations require more frequent examination and constant supervision which involves the resources of the Office of Examinations and Supervision and the District banks.

The Board has two basic options in evaluating an application for a new mutual association. The Board can approve or disapprove the application. However, in approving an application, the Board has the power to set the amount of pledged savings at the minimum level or, if the association's risk is deemed greater than normal, to set a higher amount of required pledged savings. Each new mutual association is unique and has varying opportunities for success. Despite this fact, the Board has never required organizers of an association to pledge an amount of savings higher than the minimum.

In several cases, the District banks and the Office of Industry Development disagreed as to the potential for success for certain mutual associations. In most of the cases, the Office of Industry Development recommended Board approval; but the District banks, which are the FHLBB's principal contact with the associations, recommended Board disapproval. In some instances where this occurred, the District banks' judgments on the risks involved ultimately proved correct. When the two groups have different views on the likelihood of the association's success, we believe that the Board should consider this fact in evaluating the application and setting the amount of the pledged savings requirement.

RECOMMENDATION TO THE CHAIRMAN OF
THE FEDERAL HOME LOAN BANK BOARD

The Federal Home Loan Bank Board should require organizers of new mutual associations it charters to pledge accounts in amounts greater than the minimum requirement when a District bank and the Office of Industry Development disagree about the likelihood of an association's success.

AGENCY COMMENTS

FHLBB officials from OID reviewed and orally commented on this letter. They generally concurred with the conclusions and recommendations and had specific comments concerning our analysis.

The officials expressed concern over our use of a large number of application cases from the Federal Home Loan Bank of Little Rock. They questioned whether the Little Rock Bank cases are representative of cases nationwide. As we point out in the objectives, scope, and methodology section on page 4, we included in our review all 1978 and 1980 Federal charter applications for which complete FHLBB documentation was available. Although 10 of the 17 cases we reviewed were from the Little Rock Bank, 6 were from the Atlanta Bank and 1 was from the San Francisco Bank.

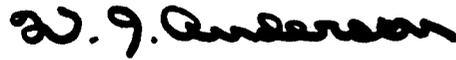
The officials stated that a difference in philosophy exists between OID and the District banks. Generally, the District banks are more conservative regarding new Federal mutual applications, and the Board and OID are more liberal. The OID officials added that, in many cases, when a District bank recommended disapproval of a Federal charter, the reasons for disapproval were not clearly supported and documented.

- - - -

Section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are providing copies of this report to the Director, Office of Industry Development, and the Director, Internal Evaluation and Compliance Office. In addition, we will provide copies to the House and Senate Committees on Appropriations, the House Committee on Government Operations, the House Committee on Banking, Finance and Urban Affairs, the Senate Committee on Governmental Affairs, and the Senate Committee on Banking, Housing and Urban Affairs.

Sincerely yours,

A handwritten signature in black ink, appearing to read "W. J. Anderson". The signature is written in a cursive, slightly slanted style.

William J. Anderson
Director