

Capital Reform for Credit Unions

WHY THE TIME FOR ALTERNATE CAPITAL IS NOW

Reduced capital ratios at credit unions, strong headwinds against net income, and an interest by policymakers in increased capital at most types of financial institutions all point to the heightened need for alternate capital for credit unions. Without access to additional forms of capital, many credit unions will be forced to curtail the growth of member service and burden members with higher loan rates and fees and lower dividend rates for years to come.

Because a credit union's only source of capital is the retention of earnings, maintaining a given capital ratio can only be accompanied by asset growth if there is sufficient net income, and increasing a net worth ratio requires even higher levels of net income or slower growth rates. This, of course, would not be the case if retained earnings could be augmented to some degree by alternate or supplemental capital (these terms are used interchangeably in this document), which would increase a credit union's capital ratio as soon as it is issued.

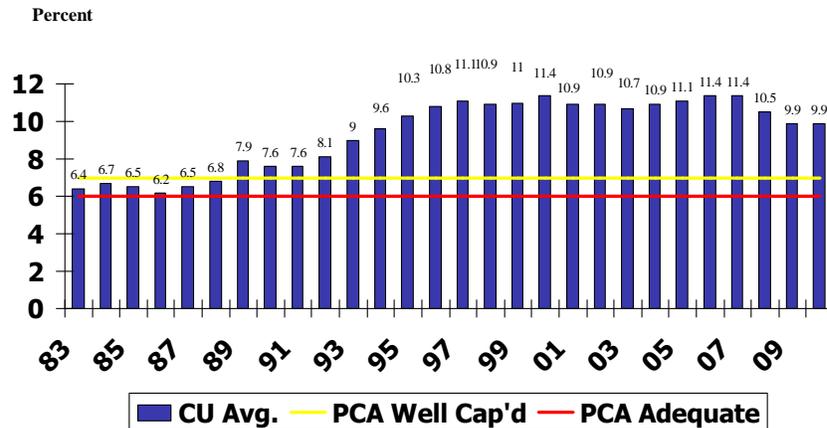
CUNA's longstanding policy "supports the authority of credit unions to build additional capital, either from members or nonmembers, in a way that does not dilute the cooperative ownership and governance structure of credit unions. This additional capital should be subordinated to credit unions' share insurance funds, so that credit unions have the financial base to offer member services and adjust to fluctuating economic conditions."

Credit unions stand out as the only depository institutions in the U.S. without the ability to issue some form of capital instrument to augment retained earnings to build capital. All other U.S. depository institutions and most credit unions in other countries are permitted various forms of alternate or supplemental capital. Given the recent declines in capital ratios reduced net income described below, the case to amend the Federal Credit Union Act to provide access to additional capital for credit unions has never been more pressing.

REDUCED CAPITAL RATIOS. As the chart below shows, credit unions have for the past decade and a half been very well capitalized. Since 1994, the average capital ratio has been 9% or higher, well above the 7% threshold to be considered well capitalized for prompt corrective action (PCA) purposes, or the 6% level for adequately capitalized. In all but three of those years the average capital ratio was above 10%. Credit unions have maintained these high capital ratios in order to maintain a sufficient cushion above the PCA thresholds, and because of the relatively risk-averse nature of their cooperative structure.

Capital to Assets

1983 to July 2010



Source: NCUA and CUNA Economics and Statistics

More recently, the financial crisis that began late in 2007 led to a substantial drop in the average credit union capital ratio, from 11.4% at the end of 2007 to 9.9% as of July 2010. There were two drivers behind this sharp decline: reduced net income and faster asset growth. Buffeted by rising loan losses caused by the recession and losses from corporate credit unions, net income averaged only 7 basis points (bp) in 2008 and 2009. In sharp contrast, return on assets had been above 80 bp in all but one of the previous 27 years. Second, as credit union members reduced their spending during the recession, credit union savings grew by almost 8% in 2008 and over 10% in 2009. This in turn contributed to strong asset growth in these two years. The combination of above average asset growth and almost nonexistent earnings caused the 1.5 percentage point decline in the average capital ratio over the period.¹

With a dollar-weighted average capital ratio of 9.9%, the credit union movement as a whole remains very well capitalized, with a cushion of almost 3% above the PCA well capitalized level. However, the financial crisis of the past two years has brought a number of credit unions close to or past the PCA triggers, as is shown in the table below.

¹ The harm the financial crisis has done to credit unions pales in comparison to its effects on many other financial institutions. Of the four largest investment banks that operated before the crisis, two no longer exist, and the other two have become bank holding companies to gain access to borrowing from the Federal Reserve. A number of huge banks and thrifts, and hundreds of medium and small ones, failed. Many others had to be bolstered by government capital infusions. Fannie Mae and Freddie Mac are under conservatorship. From the December 2007 to December 2009, the FDIC's Bank Insurance Fund coverage ratio (fund balance divided by insured deposits) plummeted from 1.22% to -0.39%.

Recent Changes in Credit Union Capital Ratios

Percent of Credit Union in Various Capital Classifications by Capital Ratio

Yearend	2007	June 2010
Inadequate (Less than 6%)	0.6%	2.3%
Adequate (6% to 7%)	0.8	3.3
Well Capitalized (Over 7%)	98.6	94.4
Merely Well (7% to 9%)	7.6	19.0
Very Well (Over 9%)	91.0	75.4
Total	100	100
Overall Average Capital Ratio	11.4	9.9

In December 2007, 98.6% of all credit unions were well capitalized, 0.8% were adequately capitalized, and only 0.6% were inadequately capitalized. By the middle of 2010, the proportion of well capitalized credit unions had fallen to 94.4%, with 3.3% adequately capitalized and 2.3% inadequately capitalized. In addition, the percentage of credit unions “very” well capitalized (capital ratio over 9%) has fallen sharply, from 91% in 2007 to 75.4% in 2010. Therefore, although most credit unions are likely to want to rebuild their net worth ratios somewhat over the next few years, fully one in four is likely to feel a very strong need to do so.

REDUCED NET INCOME. Unfortunately, the need for additional capital comes just at a time when the outlook for the only source of that capital, net income, is not particularly strong. The two factors that sharply reduced earnings during the financial crisis, loan losses and corporate stabilization, will have a diminishing negative effect on earnings going forward. However, other longer term influences on credit union net income are not promising. Net interest income, essentially the difference between what credit unions earn in interest on loans and investments and what they pay in interest and dividends on savings has been on a long-term downtrend caused by intense competition on both sides of the balance sheet. This pressure is unlikely to abate significantly going forward. In addition, interchange income, an important source of non-interest revenue, is under political pressure and is likely to diminish.

PUBLIC POLICY REVIEW OF CAPITAL REQUIREMENTS. The financial crisis has brought into sharp focus the importance of capital for all financial institutions. Some of the institutions that caused the most damage in the crisis were highly leveraged (were funded largely by debt rather than equity). Policy makers have an even keener interest than they have in the past in the importance of capital. The recently announced Basel III proposals also point to higher capital requirements for most types of financial institutions. As the economy shows increasing signs of recovering, which will allow the financial institutions still standing to also recover, higher and stricter capital requirements are likely to be imposed on financial institutions. Financial institutions themselves are likely to want to hold more capital than they did before the crisis to be better able to withstand a similar event in the future.

These factors—reduced capital ratios, reduced net income, and policy interest in more capital across the spectrum of financial institutions—all suggest that now is the time to address access to some alternate capital for credit unions. As credit unions battered by the financial crisis recover in the coming few years, rebuilding capital ratios will be paramount. Without access to alternate capital, and with earnings power facing headwinds, these credit unions and their members will face a protracted period of reduced member service, disadvantageous member pricing, and very slow growth.²

Were credit unions in this situation permitted to issue some form of alternate capital, they could immediately resume normal credit union service, pricing and growth. In the absence of access to alternate capital, current members of such credit unions would have to “pay” disproportionately for the long-term, future health of the credit union by suffering less attractive pricing and growth as the credit union built capital through the very slow process of retaining earnings.

From a public policy point of view, the economic recovery will be facilitated by financial institutions that are willing to grow and expand service. Without alternate capital, credit unions will not be able to contribute nearly as much to financing the economic recovery as they would if they were not preoccupied with slowing growth and increasing net income in order to build the ratio of retained earnings to assets.

TYPES OF ALTERNATE CAPITAL USED BY OTHER FINANCIAL INSTITUTIONS

Given the demonstrable need for access to alternate capital for credit unions, the question turns to what form(s) that capital should take. It is informative to consider first the types of capital instruments available to other financial institutions. Many of the characteristics of alternate capital used by other depository institutions would need to be replicated in versions for credit unions, although there would need to be significant modifications to account for the unique cooperative structure of credit unions.

Other depository institutions have access to a number of types of capital in addition to retained earnings. The alternate capital sources fall into two categories stemming from regulatory capital requirements: Tier 1 and Tier 2. U.S. depository institutions have two levels of required capital: a simple leverage ratio requirement and a series of risk-based requirements. For the leverage ratio (equity capital divided by total assets), only pure or almost pure equity can be included in the numerator. Such equity is referred to as Tier 1 capital. For the risk-based capital requirements (total capital divided by risk assets) additional debt-like capital sources can be added to Tier 1 capital in the numerator, and the denominator is reduced to the extent the institution holds assets with lower risk ratings. The additional capital is referred to as Tier 2 capital.

² For example, it would take nine years for a credit union with a beginning net worth ratio of 5% to reach the 7% well capitalized threshold earning 80 basis points of net income and growing by 10% each year. Cutting asset growth in half would still require four years to reach 7%, and another 5 years to reach 9%. In the alternative, if such a credit union could raise loan rates, lower dividend rates and/or raise fees enough to increase its return on assets (ROA) to 1.2%, it would take just over three years to regain a 7% net worth ratio growing by 10% a year, and another five years after that to reach 9%.

The various types of alternate capital available to other institutions share the characteristic of representing claims that come after (are junior to) those of depositors, the deposit insurance fund, and secured claimants. These instruments can absorb losses after retained earnings, but before depositors and the deposit insurance fund. Hence their value from a public policy perspective is the provision of an additional buffer for the deposit insurance fund beyond the protection provided by retained earnings. In general, the various types of alternate capital can differ according to four characteristics: their place in line in the event of loss, actual or potential governance rights, maturity, and whether dividends are cumulative or not.

LOSS ABSORBING ORDER. The most senior of the instruments (last in line to take losses before the deposit insurer) are debt instruments such as subordinated debt, which is subordinated (junior) to depositors and secured claimants, but senior to some other forms of capital. The most junior of the capital instruments is common stock, as stockholders stand first in line to absorb losses after retained earnings are depleted. In between are hybrids such as Preferred Stock and Trust Preferred Securities which are like debt in some ways, but like equity in others, or in some cases convertible to equity.³

GOVERNANCE RIGHTS. Common stockholders have full voting rights. Preferred stock and trust preferred securities can under certain conditions be converted to common stock, providing governance rights. Subordinated debt can also be convertible, plus holders of subordinated debt can be granted some governance rights such as representation of the board of directors under certain conditions. The conditional governance rights that may be granted to hybrid and debt holders are not common to or identical for all issues; they can vary for each issue. In general however, they tend to confer some control to the owners of these instruments in the event the financial condition of the institution deteriorates below certain trigger points.

MATURITY. The longer the maturity of a capital security, the longer it stands available to absorb losses, and hence the greater protection it provides the deposit insurance fund. Common stock and some preferred stock are perpetual; they never mature. The other hybrid and debt instruments can have different maturities. Typically, capital instruments with remaining maturities beyond five years can be counted fully toward at least Tier 2

³ Preferred Stock is a type of security with features that can vary widely, but they generally are perpetual, have a stated dividend rate, are nonvoting, and can be convertible. Trust Preferred Securities are a hybrid debt/equity security where the issuing institution establishes a trust that sells preferred shares to investors and uses the proceeds to purchase very long-term subordinated debt from the issuing institution. These complex transactions have the result that the issuing institution can count the proceeds as Tier 1 capital, can deduct the interest paid for the sub-debt from taxable income, and the “interest” received by investors is taxed as ordinary dividends. The recently passed Dodd-Frank Wall Street Reform and Consumer Protection Act eliminated Tier 1 treatment for new issues of Trust Preferred Securities for holding companies with assets over \$500 million. For more information on the use of subordinated debt and Trust Preferred Securities by U.S. financial institutions, and implications for credit unions see: James A. Wilcox. “Subordinated Debt for Credit Unions.” Filene Research Institute, October 2002, and James A. Wilcox. “Capital Instruments for Credit Unions: Precedents, Issuance and Implementation.” Filene Research Institute, February 2003.

capital requirements. As the remaining maturity falls below five years, the amount of the funds that counts as capital falls by 20% each year.

RELATIVE CERTAINTY OF DIVIDEND PAYMENTS. Cumulative dividends have the characteristic that if the institution is unable to pay dividends in any period, the obligation to pay those dividends rolls over into future periods. With non-cumulative dividends, the security holder has no claim in future periods to any dividends that were not paid in previous periods. Because instruments with non-cumulative dividends are more “equity like,” they provide more of a buffer to the deposit insurance fund. In difficult times, the nonpayment of dividends can protect retained earnings which might otherwise have to be drawn down to make contractual dividend payments.

Of the four characteristics that can differentiate types of alternate capital, three are important in determining how valuable the type is from the perspective of the deposit insurer, and whether the type qualifies as Tier 1 or Tier 2 capital. Generally, the more junior the instrument (the closer to the front of the line in absorbing losses), the longer the maturity, and the more non-cumulative the dividends, the more “equity like” the instrument, and the greater its chances of qualifying as Tier 1 capital. In the US, capital instruments that currently qualify as Tier 1 capital for banks and thrifts (in addition of course to retained earnings) are common stock and perpetual, non-cumulative preferred stock and trust preferred securities. All other preferred stock and subordinated debt qualify only as Tier 2 capital.

ALTERNATE CAPITAL FOR CREDIT UNIONS

An understanding of the types of alternate capital available to other financial institutions is a good starting point for considering how alternate capital might work in credit unions. However, in developing sources of alternate capital for credit unions, not all of the forms available to other depository institutions will be appropriate, because of credit unions’ unique cooperative structure. Alternate capital would need to be created so that it in no way harms that structure. Specifically, the development of alternate capital would need to adhere to the following principles:

- Cooperative Ownership Structure. Alternate capital must have no effect or potential effect on the cooperative ownership structure of credit unions. The ownership of the credit union must remain in the hands of the members of the credit union, regardless of whether they have provided any alternate capital. In the event alternate capital is provided by nonmembers, it can confer no ownership rights. Thus, common stock must be ruled out as a source of alternate capital for credit unions. And of course, without common stock, no debt or hybrid instrument could be convertible to common stock.
- Governance. Alternate capital must have no effect or potential effect on the ability of member-elected boards to govern their credit unions. Governance must continue to be driven by one member, one vote with no special or additional voting rights for providers of alternate capital. In the event alternate capital is issued to nonmembers, it can confer no governance or voting privileges, either at

the time or issuance or conditional on the future operations of the credit union. Thus, covenants in subordinated debt or hybrid agreements that provide governance rights to investors in certain situations (such as a deterioration of the financial condition of the credit union) cannot be permitted.

- Tax Exempt Status. Alternate capital would need to be authorized and implemented in a way that has no adverse effect on the tax exempt status of credit unions. This would in part be accomplished by meeting the previous two criteria on ownership and governance. The preservation of the tax exemption would best be reinforced by a statement in the enabling legislation that such capital does not in any way change the tax exempt status of credit unions.

In addition to these characteristics, alternate capital sources would need to meet other requirements to serve credit unions' purposes effectively:

- Protection. Alternate capital must provide real protection to the National Credit Union Share Insurance Fund (NCUSIF). Any source of alternate capital must be unambiguously junior to the claims of the share insurance fund. It must also be of sufficient maturity to serve as capital. Finally, to achieve the highest status as capital, some forms may need to have non-cumulative dividends.
- Disclosure. Investors in credit union alternate capital must be completely and totally aware of the risks of the instrument. This is not only fair to investors, but also it strengthens the value of the capital in protecting the NCUSIF. To the extent investors are not really aware of their risks, the more difficult it is to pass losses on to the instrument, i.e., the less protection would it provide to the insurance fund. Any loss to an investor in an alternate capital instrument might come as a major disappointment, but it should not come as a total surprise. This requires simple and clear disclosures to investors of the risks of investing in alternate capital, with particular care to distinguish between uninsured alternate capital and insured share certificates.
- Suitability. Credit union alternate capital must be "suitable" to the investors that purchase it in the case that the investor is not an institutional investor, for example a member. Suitability requirements go beyond disclosure. An investment is suitable to an investor if he or she has sophisticated investment knowledge, and/or experience investing in similar types of instruments and/or sufficient net worth so that a substantial loss on the investment would not unduly harm the investor. A suitability requirement might obligate a credit union to determine whether the purchase of a subordinated capital certificate is appropriate for a member. Examples of the sorts of steps the credit union might need to take include: determining the member's experience with uninsured investments, determining the member's risk tolerance by use of standard questionnaires, determining the total financial assets or net worth of the member, and limiting the amount of an alternate capital investment to some small fraction of financial assets or net worth.
- Practical. Alternate capital must be practical for credit unions to acquire. Some of the capital instruments currently available to depository institutions are only appropriate for very large firms. There must be vehicles for smaller credit unions to reasonably gain access to alternate capital if they wish to. This could take the

form either of offering “retail” capital instruments to members, or conducting joint offerings in the capital markets in partnership with other credit unions.

- Optional. Alternate capital should be optional for credit unions. For those credit unions willing and able to operate with only retained earnings, there should be no requirement that they also acquire alternate capital.

Because of the many features, possible characteristics and requirements of alternate capital, there is no single or simple form that would be appropriate for all credit unions seeking alternate capital. There are many possible variations on the theme of allowing alternate capital to augment retained earnings and to provide extra protection for the share insurance fund. Therefore, credit unions would best be served by having as many options as possible, so long as they meet the above criteria. Also, through time, the types of instruments available in the capital markets that might serve as alternate capital for credit unions will change. Therefore, enabling legislation should describe the principles governing alternate capital instruments to be made available to credit unions, subject to state and federal supervisory authority rulemaking, rather than being overly specific about types of instrument. With that said, the following are some examples of the alternatives among which credit unions should be permitted to follow to construct their alternate capital instruments:

- The Source of the Alternate Capital. Credit unions should be permitted to offer alternate capital instruments to both members and nonmembers. For some types of alternate capital (especially subordinated debt and securities similar to trust preferred securities) there may not be enough “suitable” investors from among the membership. There are markets for larger credit unions, or groups of credit unions, to access alternate capital from the open capital markets, and credit unions should not be denied access to this source. Of course, there would need to be safeguards in the securities to completely protect the cooperative ownership and governance of the credit union. Even if subordinated certificates were offered only to members on a voluntary basis, there would need to be protections so that holders of their certificates were not granted any ownership and governance rights beyond those pertaining to all other members.
- Mandatory or Optional. For alternate capital that is gathered from members, the credit union should be able to choose to make the investment mandatory or optional. This will be discussed below in the section of instruments.
- Debt or Equity. Credit unions should be able to construct capital instruments that are either debt or equity. Pure equity capital could only come from members, and not all member capital could be equity (see below). Debt capital could come from any source. Debt capital could be structured so that it could qualify as Tier 1 capital, but without equity ownership rights.

There is also the issue of how alternate capital might count toward net worth requirements. There are two general approaches that could be taken in this regard: as Tier 2 capital in combination with a risk-based capital approach, or as modified Tier 1 capital, or a combination of these approaches.

Tier 2 Alternate Capital with Risk-Based Capital Requirements.

Similar to the current bank model, under this approach, the various forms of alternate capital would qualify only as Tier 2 capital and would qualify only for risk-based capital requirements, and not the leverage ratio. The risk-based requirements could be based on a Basel type system, tailored by credit union supervisory authorities to the needs and circumstances of credit unions. For this approach to have any benefit for credit unions, it would have to be accompanied by a reduction in the leverage ratio, the ratio of retained earnings to total assets. Without a reduction in the required leverage ratio, no amount of Tier 2 capital to meet new risk-based requirements would be of any benefit to credit unions in meeting the basic leverage ratio. Of course, if credit unions were to face new risk-based capital requirements in addition to a required leverage ratio, a reduction in the required value of the leverage ratio would be completely appropriate from a public policy perspective given the existence of the risk-based requirements in reducing risk and requiring sufficient capital to meet risks. Nevertheless, in the current post-financial crisis political environment, the likelihood of Congress lowering credit unions' leverage requirement, regardless of how robust a risk-based Tier 2 capital approach is incorporated, is minimal.

Alternate Capital as Tier 1 Capital.

Under this approach, various types of alternate capital could be included in Tier 1 capital. The extent to which the alternate capital could be included as Tier 1 would depend on the characteristics of the source. The greater the protection provided to the NCUSIF, the more the instrument could be included in Tier 1 capital. The credit union supervisory authorities would determine the parameters that define the extent to which any given source of alternate capital could be included in the credit union's Tier 1 capital. Under this approach, the leverage requirements to be adequately and well capitalized would not change, but credit unions would have access to additional forms of capital to meet them. Although the details would appropriately be established by the supervisory authorities under broad legislatively mandated principles, an example of how such an approach might work follows:

- Permissible as Tier 1 capital without limit: retained earnings; pure member equity; very long-term (perpetual or initial maturity of over 20 years) non-cumulative securities.
- Permissible as Tier 1 capital up to a limit: debt or hybrid securities with initial maturities of at least five years. The limit could be as a percent of assets (for example, no more than 3% of assets) or as a proportion of Tier 1 capital (for example, no more than 50% of total Tier 1 capital.)
- In all cases of securities with a maturity, the amount of the instrument that counts toward capital would decline by 20% a year in the last five years before maturity.
- Securities could be callable at the option of the issuing credit union, but only if all capital requirements would be met after the call.

- Securities could be transferred among eligible owners at the discretion of the credit union.

Combination: Alternate Capital as Tier 1 and Tier 2 Capital.

This approach would be similar to current bank capital requirements. Credit unions would face both a leverage requirement based on the ratio of Tier 1 capital to total assets, and a risk-based requirement based on the ratio of total capital (Tier 1 plus Tier 2) to risk-based assets. Alternate capital that meets the requirements above would qualify as Tier 1 capital, all other alternate capital would be Tier 2, subject to the amortization of eligibility as the remaining maturity fell below five years.

POSSIBLE TYPES OF ALTERNATE CAPITAL FOR CREDIT UNIONS

With the previously discussed considerations and issues in mind, we turn now to the types of capital instruments that credit unions might have access to once alternate capital is permitted through legislative and regulatory changes.

ALTERNATE CAPITAL FROM MEMBERS

- Mandatory Membership Shares. A credit union could, at its option, require all members to own a single membership share. Membership shares would be uninsured and non-withdrawable so long as the person remains a member of the credit union. Membership shares would take the first loss after undivided earnings. Establishment of membership shares could take the form of converting the current par value of a share to a membership share, or establishing different value for the membership share, based on the credit unions needs. On average for US credit unions, each \$25 of membership shares would represent about 25 basis points of assets, although this varies according to a credit union's ratio of assets to members. An option for credit unions that choose to require membership shares would be to allow a waiting period for the purchase of the full membership share. For example, members could join without purchasing a membership share for a year before making the investment. As long-term equity, membership shares would qualify as Tier 1 capital. Additional characteristics that supervisory authorities may wish to consider are whether dividends on membership shares could be paid out of undivided earnings (i.e., should dividend payments be limited only to periods with positive current earnings), whether dividends should be non-cumulative, and whether the credit union may require a delay of redemption upon termination of membership under certain circumstances.

Instead of, or in addition to, dividends on membership shares, credit unions could use membership shares to pay an annual patronage dividend to members. Under this arrangement, each year a credit union would assign a certain portion of its net income to paying a patronage refund based on the total amount of business the member conducted with the credit union during

the year: loans, savings, and transactions services that produce fee or other revenue for the credit union. This would allow each member's membership share to grow through time, depending on his or her use of the credit union. Amounts would not be withdrawable until termination of membership, or in installments when the member reaches a certain age, 65 for example. Because membership shares would count fully as Tier 1 capital, this approach would allow a credit union to "assign" a certain portion of its net worth explicitly to members by each year allocating a portion of net income to the patronage dividend.

- Optional Membership Capital. A credit union could offer optional capital instruments that members would be under no obligation to buy. The optional forms could be either equity or debt. Equity instruments could be in the form of perpetual obligations that are only redeemed some time after the termination of the membership, and then perhaps only under certain circumstances regarding the capital position of the credit union, e.g. only if the credit union is well capitalized. They could also be callable at the option of the credit, again under certain circumstances. Optional debt instruments could be subordinated certificates to members in various denominations. Subordinated certificates would be uninsured, and subordinate to all shares and deposits (except membership shares if they exist) and the share insurance fund. Both optional perpetual member equity and subordinated certificates would require explicit and clear disclosure to the purchasing member, and an obligation on the part of the credit union to ensure that the member is a suitable investor. Optional perpetual member equity would qualify as Tier 1 capital. If a class of subordinated certificates had the appropriate characteristics as determined by the supervisory authorities, it could also qualify as Tier 1 capital. This would likely require a very long initial maturity, and non-cumulative interest payments. All other subordinated certificates would qualify as Tier 2 capital. Neither perpetual member equity nor subordinated certificates could confer any additional ownership and governance rights on members who purchase them. In fact, subordinated certificates would represent less of an ownership interest than regular shares and deposits in that they would be junior to shares and deposits (with the exception of membership shares) in the event of liquidation.

ALTERNATE CAPITAL FROM NONMEMBERS

- Subordinated Debt. Any capital from nonmembers would mostly take the form of some type or variant of subordinated debt. A credit union could offer subordinated debt to nonmembers in various denominations, at the option of the credit union. Subordinated debt would share all of the characteristics of member subordinated certificates, except it would be sold to nonmembers. The sale of subordinated debt would likely require compliance with Securities and Exchange Commission rules, although a private placement may not require SEC registration. Because of the costs involved, individual issuance of subordinated debt would likely only be

feasible for very large credit unions, with the exception of purchases from organizations familiar with a credit union, e.g. sponsors. However, groups of smaller credit unions could issue subordinated debt in a pooled structure, with other credit unions.⁴ If subordinated debt is issued to outside investors, particular care will have to be taken to disallow any restrictive covenants in the debt agreement that could confer governance rights to debt holders under any circumstances. Subordinated debt would most likely count only as Tier 2 capital, but some issues could count as Tier 1 capital depending on their characteristics, e.g. very long maturity and non-cumulative interest payments. It is also possible that Trust Preferred Securities or some similar vehicle might be available to credit unions. Such securities could be treated as Tier 1 capital depending on their characteristics.

CONCLUSION

A compelling case can be made that under appropriate rules and guidelines that preserve the cooperative ownership and governance of credit unions, access to alternate capital would be good for credit unions, their members, and the economy. Given the importance of adequate capital to the nation's federal deposit insurance systems, extending authority to credit union regulators to permit access to alternate capital would also provide additional protection to the U.S. taxpayer.

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⁴ For a discussion of the pooling concept in issuing alternate capital, see Wilcox, 2003.