The question of whether credit unions should be permitted to issue some form of secondary capital has been raised. The genesis of recent interest is the new capital requirements for credit unions embedded in Prompt Corrective Action rules, but there has long been an interest in the topic. One of the Renaissance Vision Statements adopted by the CUNA Board states:

*Credit unions must have the ability to build additional capital 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 these services and adjust to fluctuating economic conditions.*

This document presents some of the possible features and characteristics of additional capital, also referred to as secondary or alternative capital.

**PURPOSE OF SECONDARY CAPITAL:** The issuance of some form of alternative capital would allow credit unions to augment the only current source of capital they have, retained earnings. This is important because earnings retention is a time consuming process. Secondary capital would allow a credit union that needs to do so to quickly build it’s capital. Advantages of secondary capital are that it would provide additional stability, allow growth, permit product and service enhancements, and could meet a portion of statutory and regulatory capital requirements.

**FORM:** Credit union secondary capital could take on a number of forms, depending on the source of the funds. If the funds derive from the credit union’s members, secondary capital could take the form of uninsured shares. If the source of the funds is not the members of the credit union, the most likely model for secondary capital would be subordinated debt, with the following characteristics:

- **SUBORDINATED:** The claims of holders of secondary capital against a credit union would come after certain other creditors and claimants, including insured shares, deposits, creditors and the share insurance fund.
- **DEBT:** Secondary capital would not represent an ownership interest in a credit union. Its holders would have no voting rights. It would need to be structured so that it would not interfere with the cooperative ownership and governance of each credit union by its members.

Subordinated debt is not strictly speaking “capital” in that it would not represent an equity interest in the credit union. Instead it would be borrowing by a credit union that does not compromise the cooperative ownership and governance of the credit union. Although debt, it would be at risk and thus would encourage risk management by a credit union (through pricing of the debt) and vigilance over that risk management by debt holders. In the event of the liquidation
of a credit union, its holders would be paid only after the share insurance fund had been paid. For this reason, and because of its risk management incentives, it would provide additional protection from losses to the share insurance fund and ultimately to taxpayers.

SOURCES OF FUNDS: Secondary capital could come from members, other components of the credit union system, and/or outside investors. Each source has philosophical, political, and operational advantages and disadvantages. It is unlikely that one form of secondary capital will be optimal for all credit unions that need additional capital. Therefore, a variety of sources and types from which individual credit unions could choose will be beneficial.

MEMBERS: Alternative capital could be generated from members in two ways. First, at its option a credit union could require each member to purchase a modest amount of uninsured membership shares as a condition of membership. Unlike the debt instruments covered in the rest of this paper, these membership shares would actually be equity rather than debt. As equity, membership shares would automatically stand ahead of the share insurance fund in the event of the need to absorb losses. This would spread a small amount of risk over all members, and could be used as an educational tool to remind members of the cooperative nature of their credit union. On the other hand, it could be off-putting to many members. A credit union would have the choice of whether or not to raise capital with this device. The total amount of capital that could be generated in this way would be noticeable, but not substantial for most credit unions. On average, $10 per member would generate about 0.15% of assets. Most credit unions currently have a minimum share deposit of $5, $10, or $25 (a few require more), but these are simply part of the member’s insured savings account. They are not separate, uninsured accounts. If they were uninsured membership shares, they would, on average generate additional capital to assets of about 8 basis points, 15 basis points, or 40 basis points, respectively.

The second way to generate secondary capital from members would be to issue certificates of indebtedness to members that are subordinated to all other claimants on the credit union. This is essentially subordinated debt issued to members. Members could choose whether or not to purchase such certificates. Members holding these certificates would not be entitled to any special ownership or voting rights beyond those available to all members. Disclosure of the non-insured, at-risk nature of these investments would have to be explicit. With amounts of $500, $1,000, $5,000, $10,000 and perhaps more, significant amounts could be raised.

NONMEMBERS, IN THE CREDIT UNION MOVEMENT: Credit unions might issue subordinated debt to other credit unions. There would probably need to be limits on the amount an investing credit union could purchase, for example a percentage of the investing credit union’s assets or net worth. Also, credit unions that were not themselves “well-capitalized” could be excluded from purchasing the subordinated debt of other credit unions. Such an arrangement would have some of the characteristics of the old “stabilization funds” that predated the National Credit Union Share Insurance Fund (NCUSIF), i.e., credit unions helping other credit unions, except in this case the assistance would be proactive rather than remedial. An advantage of this system is that credit unions are probably very good judges of the viability of other credit unions, so the pricing of subordinated debt would accurately reflect the relative riskiness of credit unions. Riskier credit unions would have to pay higher rates, or would not be able to attract funds. Issuing credit unions would have an incentive to minimize risk to minimize the cost of debt issuance. Really weak credit unions would not be able to generate additional capital through subordinated debt; no other credit union would be willing to purchase the debt. With such a
system, very well capitalized credit unions would be permitted, on a limited basis, to capitalize less well capitalized, but healthy credit unions.

OUTSIDE INVESTORS: Credit unions could also be permitted to issue subordinated debt to outside investors. They could issue debt to any investor interested in purchasing the security. This would open up significant amounts of additional capital. An advantage of this system is that there is already an established market for subordinated debt issued by financial institutions, although it tends to be used only by larger institutions. Thus, this avenue would likely be available only to the largest credit unions unless a debt issuing pass-through pool were developed. A value of the use of subordinated debt is that the debt holders would represent an additional party (to the share insurer/regulator) scrutinizing the financial condition of the credit union.

MATURITY: To be effective, secondary capital should have a long enough maturity to provide real protection to the share insurance fund. Also, it would be useful for an issuing credit union to have to go the market with some frequency, to be exposed to the discipline of the market in pricing the debt. Maturities of three to five years would likely be sufficient. And, only a given proportion of the debt would be able to come due in any year, for example, no more than a third. Another option would be to count as alternate capital only that portion of outstanding issues for which the remaining maturity exceeds a certain time period, say a year.

COST: Since secondary capital holders would take on risk of loss of their funds should the credit union fail, they will expect to receive a higher rate of return than on risk-free, fixed-rate investments such as Treasury securities or federally insured deposits. Likely spreads above risk-free rates might range from two to five percentage points. Assuming a three-percentage point premium over Treasury securities, for each one-percentage point of assets a credit union issued in secondary capital, the annual cost to the credit union would be 3 basis points on assets. [This assumes the credit union invests the proceeds of issuing secondary capital at the current yield on Treasury securities. The actual cost would depend on the way the additional funds are invested or lent out by the credit union.] At these terms, a two-percentage point boost in the capital ratio generated by secondary capital would cost about 6 basis points of assets per year. That’s about 6% of recent average annual net income of about 95 basis points.

SECONDARY CAPITAL AND PCA CAPITAL CLASSIFICATIONS: There are a number of ways that secondary capital could function in meeting PCA capital requirements. On the one extreme, alternate capital could be totally substitutable for retained earnings to meet PCA requirements. In this case, a credit union would be permitted to meet all of its net worth requirements with secondary capital, without a requirement to hold any retained earnings. In the alternative, there could be limits imposed on the ability of secondary capital to meet PCA requirements. This is similar in principle to limits placed on the use of Tier II capital by banks in meeting their capital requirements, considering credit union retained earnings as analogous to banks’ Tier I capital. The limits could vary depending on the type of secondary capital, for example membership shares as opposed to subordinated debt. These limits could take a variety of forms.

MINIMUM RETAINED EARNINGS. One approach would require a minimum amount of retained earnings (below the current PCA requirements) and then allow the use of secondary capital to meet PCA required levels above that minimum. For example, if the minimum net-worth ratio were 4%, secondary capital could comprise the other 2% to be “adequately” capitalized (6%) and the other 3% to be “well” capitalized (7%). Also under this approach,
so long as the minimum net worth ratio were maintained, secondary capital could be used to meet a credit union’s risk based net worth requirement should it exceed 6%.

SECONDARY CAPITAL LIMITED TO A MULTIPLE OF RETAINED EARNINGS. Another approach would allow the use of secondary capital, but only in some multiple of retained earnings. The lower the multiple, the greater the proportion of total capital that would have to take the form of retained earnings. For example, if retained earnings were 5% of assets:

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<th>MAXIMUM SECONDARY CAPITAL</th>
<th>MAXIMUM TOTAL CAPITAL</th>
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<td>One</td>
<td>5%</td>
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<td>75%</td>
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<td>66%</td>
<td>3.3%</td>
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<td>Half</td>
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COUNTING ONLY A PORTION OF SECONDARY CAPITAL. Finally, the amount of secondary capital that could count toward PCA requirements might be only a portion of the amount of secondary capital actually held. This would provide even greater protection for the share insurance fund. If that portion were, for example, three quarters, a credit union would need to hold 2% in assets of secondary capital for each 1.5% increase in its net worth ratio. If the portion were one half, a credit union would need to hold 2% of assets in secondary capital for each 1% increase in its capital ratio.

SUMMARY. The specific details of what sorts of instruments would qualify as additional capital for credit unions, and what if any limits should apply are likely best set by the National Credit Union Administration in conjunction with the state supervisory authorities. But, there are a number of options available that draw on already existing debt capital instruments that are known to encourage risk management and provide additional protection to deposit insurance systems. The public interest would be served by allowing credit unions these tools that would: permit them to grow and serve more Americans who need their services, minimize the exposure to the share insurance system, and maintain the cooperative ownership and control of credit unions by their members.

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