April 12, 2010

The Honorable Debbie Matz  
Chairman  
National Credit Union Administration  
1775 Duke Street  
Alexandria, VA  22314

The Honorable Michael E. Fryzel  
Board Member  
National Credit Union Administration  
1775 Duke Street  
Alexandria, VA  22314

Dear Chairman Matz and Board Member Fryzel:

I am pleased to share with you the white paper prepared by the Supplemental Capital Working Group (Working Group).

In December 2008, I launched an initiative to accelerate consideration of supplemental capital approaches in my role as liaison to the National Association of State Credit Union Supervisors (NASCUS). Specifically, the initiative sought to explore NCUA’s current authority to permit federally insured credit unions to offer supplemental capital, to identify key public policy considerations for any extension of NCUA’s authority to permit the issuance of supplemental capital by federally insured credit unions and to set forth the Working Group’s observations and conclusions on the risk management, regulatory safety and soundness and consumer protection issues that should be addressed to appropriately implement supplemental capital.

While credit union capital levels are good—9.91% net worth ratio as of December 31, 2009—U.S. credit unions remain the only financial institutions that do not have access to sources of capital beyond retained earnings. The unprecedented economic crisis in this country and the toll it is taking on every facet of the financial services industry including credit unions have spurred more vigorous discussion within the credit union system about supplemental capital. I believe this white paper provides a unique perspective on the issue—a perspective that tries to balance the public policy considerations with the risk management issues associated with broader statutory authority to permit supplemental capital to count towards Prompt Correct Action “net worth” requirements.

In preparing this white paper, the Working Group assembled and evaluated existing external and agency research on supplemental capital for credit unions, both in the U.S. and in other countries’ credit union systems. The Working Group also analyzed the agency’s experience with supplemental capital at low-income designated credit unions and corporate credit unions. The Working Group developed possible models for supplemental capital that adhere, with varying degrees of success, to the identified public policy considerations. In developing
its conclusions, the Working Group sought to balance NCUA’s experience with supplemental capital and risk management issues, including systemic and reputation risk, with the recognition that supplemental capital authority can be implemented in a manner consistent with the cooperative, mutual credit union model. The Working Group sought and considered input from a variety of sources.

Permitting federally insured credit unions to accept supplemental capital that counts towards statutory net worth provisions requires Congressional action. The Working Group recognizes that many of the identified safety and soundness and investor safeguards would need to be implemented in much greater depth through regulations. However, it is the conclusion of the Working Group that supplemental capital is an appropriate policy consideration.

Sincerely,

Christiane G. Hyland
Board Member

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<tbody>
<tr>
<td>AFS</td>
<td>Available for Sale</td>
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<td>ALLL</td>
<td>Allowance for Loan and Lease Losses</td>
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<td>BASEL</td>
<td>BASEL Capital Accord</td>
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<td>CPA</td>
<td>Certified Public Accountant</td>
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<td>CUMAA</td>
<td>Credit Union Membership Access Act</td>
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<td>Federal Credit Union</td>
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<td>FICU</td>
<td>Federally Insured Credit Union</td>
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<td>FDIC</td>
<td>Federal Deposit Insurance Corporation</td>
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<td>GAO</td>
<td>U.S. Government Accountability Office</td>
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<td>Generally Accepted Accounting Principles</td>
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<td>Membership Capital Account</td>
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<td>Mandatory Membership Capital</td>
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<td>NASCUS</td>
<td>National Association of State Credit Union Supervisors</td>
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<td>NCUSIF</td>
<td>National Credit Union Share Insurance Fund</td>
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<td>NWRP</td>
<td>Net Worth Restoration Plan</td>
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<td>PCA</td>
<td>Prompt Corrective Action</td>
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<td>PIC</td>
<td>Paid in Capital</td>
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<td>SMSIA</td>
<td>Standard Maximum Share Insurance Amount</td>
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<td>U. S. Department of Treasury</td>
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<td>Trust Preferred Securities</td>
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Executive Summary

All credit unions rely almost exclusively on retained earnings to build capital. Two types of credit unions, low-income designated credit unions and corporate credit unions, are permitted forms of supplemental capital (also called “alternative capital,” “contributed capital,” or “secondary capital”). With the advent of prompt corrective action (PCA) for credit unions, Congress limited the definition of “net worth” (the credit union version of regulatory capital) to retained earnings as defined by generally accepted accounting principles (GAAP). Thus, other forms of capital cannot legally be counted as “net worth” for federally insured, natural person credit unions other than those with a low-income designation. A change in the law would be required to permit all federally insured credit unions to count supplemental capital in PCA ratios. NCUA cannot count other sources of capital as “net worth” by regulation.

NCUA currently has very limited authority to establish supplemental capital that would benefit federally insured credit unions by enhancing their “net worth” for PCA purposes. While low-income designated credit unions can offer supplemental capital (known as “uninsured secondary capital”) to nonmembers that counts toward PCA “net worth,” all other federally insured credit unions are limited to issuing subordinated debt which does not meet the PCA definition of “net worth.” From a capital standpoint, this leaves only a small subset of federally insured credit unions that would benefit from issuing supplemental capital in the form of subordinated debt. Moreover, the Federal Credit Union Act does not permit NCUA to adjust a federally insured credit union’s net worth ratio or increase its net worth classification to reflect the regulatory capital it holds, nor to exempt it from the “mandatory supervisory actions” that apply. The NCUA has advanced two PCA reform proposals that resolve several of the concerns of the credit union system relative to capital requirements and the adverse impact from PCA. The proposals incorporate a lower leverage ratio requirement with a more robust risk-based capital standard. This puts additional emphasis on credit unions understanding and measuring the risk of activities, services or operations in relation to their capital level.

In preparing this white paper, the Working Group reviewed a variety of research papers, reports and statutory and regulatory provisions that govern supplemental capital for other financial institutions. The Working Group also reviewed NCUA’s supervisory experience with low-income designated credit unions and corporate credit unions. The Working Group had significant dialogue on regulatory issues with state regulators from the National Association of State Credit Union Supervisors (NASCUS), as well as fellow regulators from Canada and Australia. Based on this information and its own internal dialogue and debate, the Working Group concluded that any form of supplemental capital for credit unions should adhere to three key public policy principles: (1) preservation of the cooperative mutual credit union model; (2) robust investor safeguards; and (3) prudential safety and soundness requirements.

The Working Group reviewed various approaches to supplemental capital instruments that could be adapted for federally insured credit unions in the United States to meet the key public policy principles outlined above. All models contain two important characteristics: (a) the source of the supplemental capital – members versus external investors, including the important consideration of whether the investor is a natural person or an institution and (b) the equity characteristics of the capital instrument – characteristics that fall along a continuum from full equity instruments (e.g., perpetual, reflect ownership, governance implications) to less permanent or pure hybrid debt/equity instruments.

The Working Group concluded that affording credit unions the ability to raise supplemental capital that counts towards PCA “net worth” requirements is an appropriate policy consideration. However, the Working Group firmly believes that if such authority is granted by Congress, it must be done in the context of the key policy principles enunciated in this white paper. This white paper is an effort to balance all of the considerations (e.g., mutuality, robust investor disclosures, safety and soundness, and the need for credit unions to expand their
access to capital) in order to evaluate the propriety of expanding supplemental capital for federally insured credit unions.

The Working Group developed three general categories (by claim priority) for the types of supplemental capital instruments that could satisfy to various degrees the key public policy principles include: Voluntary Patronage Capital (VPC), Mandatory Membership Capital (MMC), and Subordinated Debt (SD).

VPC would be uninsured and subordinate to the National Credit Union Share Insurance Fund (NCUSIF), and would be used to cover losses that exceed retained earnings. These instruments are intended to allow members with the financial wherewithal, under strict suitability and disclosure standards, to support the credit union by contributing capital. Purchase of this type of supplemental capital instrument would be optional for natural person members, but not available to institutional members. Voting rights and access to all credit union services otherwise available to members may not be contingent in any way on the purchase of VPC. This type of supplemental capital would function as equity, not debt, as it is a very long term, noncumulative capital instrument. Given its utility as capital, VPC would count toward both the net worth ratio and the risk-based net worth ratio, but subject to certain limits given mutuality and risk considerations.

MMC would function as equity, not debt, as it approximates a perpetual, non-cumulative capital instrument. Purchase of this type of supplemental capital would be a condition of membership for any person or entity eligible to join the credit union. The idea behind this form of capital is to allow credit unions to convert the par value share currently required to be a member of the credit union in good standing to a form of supplemental capital. Specifically, the minimum single par share which a member is required to “purchase” to be a member of the credit union would be uninsured and subordinate to the NCUSIF. Subject to prior regulatory approval, individual credit unions would opt-in to this type of membership structure by adoption of a standard bylaw amendment.

Given its utility as capital, MMC would count without limit toward both the net worth ratio and the risk-based net worth ratio. It is intended to reflect the cooperative “ownership” and voting rights every member of the credit union has, without changing the one member-one vote principle. It more explicitly reflects each member’s ownership stake in the credit union.

SD is the third general category that could satisfy to various degrees the key public policy principles. SD would be uninsured, subordinate to the NCUSIF, and would be used to cover losses that exceed retained earnings and any MMC or VPC capital. It would have a 5-year minimum initial maturity or notice period with no early redemption option for the investor. Credit unions issuing SD would need to be subject to standard marketplace investor suitability standards and disclosures. SD may not convey any voting rights, involvement in the management and affairs of the credit union, or be conditioned on prescriptive measures directing the credit union’s business strategies. This type of supplemental capital would function as a hybrid debt-equity instrument. It is the Working Group’s belief that this type of capital instrument should be limited to institutional investors, regardless of whether such investors are members of the credit union or external. Given the debt characteristics and shorter minimum initial maturity, SD would only count toward the risk-based net worth ratio, and only up to 50% of capital instruments (including retained earnings) counting toward the net worth ratio.

The Working Group’s conclusions must be understood in the context of the risk management and safety and soundness issues identified herein. NCUA’s experience with the depletion of supplemental capital accounts at corporate credit unions and low-income designated credit unions does raise reservations with the Working Group. Specifically, the Working Group is concerned that even heightened disclosure will be insufficient to fully inform investors of the risk and uninsured status of supplemental capital accounts. The Working Group also acknowledges that both the corporate network and the historical loss nature of low-income designated credit unions present similar challenges to the general natural person credit union population. Regulators will
have to promulgate and enforce disclosure standards sufficient to inform prospective investors of the risks and uninsured status of such supplemental capital accounts.

Congressional action is required to implement additional forms of supplemental capital for natural person credit unions beyond the existing secondary capital for low-income designated credit unions. Further, to ensure that such capital is reflected in the issuing credit union’s “net worth ratio,” which determines its net worth classification under PCA, it will be necessary for Congress to expand the statutory definition of “net worth” accordingly and to make other conforming adjustments to the statutory criteria for PCA. The Working Group identified areas in the Federal Credit Union Act that would need revisions to accommodate supplemental capital as well as to make further statutory enhancements to improve and simplify the implementation of PCA generally, in light of the last eight years of implementation experience. The Working Group recognizes that the safety and soundness as well as investor safeguards would need to be enunciated in much greater depth through any implementing regulations.

The Working Group also conducted an analysis based on the three categories of supplemental capital to assess how supplemental capital could impact credit unions. The analysis helps quantify the potential financial benefit to credit unions and may be helpful in assessing whether the benefits outweigh expending political capital in the pursuit of a legislative change in this area. The impact of supplemental capital was evaluated using three scenarios: “Maximum Benefit”: The maximum amount of supplemental capital that could be raised applying reasonable limitations; “Potential Benefit”: The amount of supplemental capital that could be raised taking into account the limited resources of smaller credit unions and exclusion of all credit unions with current capital levels well in excess of regulatory requirements; and “Expected Benefit”: An estimate of the amount of supplemental capital that could be raised by the credit unions likely to engage in the activity. To a large degree, benefits are dependent upon a credit union’s asset size as utilization of all the supplemental capital options will require retention of expertise in securities regulation along with robust capital measurement and planning. The Working Group acknowledges that there are benefits that are less quantifiable: the regulatory benefits to supervisory agencies of having the ability to provide flexibility to well-managed credit unions; the benefits to implementing supplemental capital to facilitate the likely increase in credit union mergers; the general leveling of the playing field between U.S. natural person credit unions and every other depository institution worldwide; and the potential for increase in members’ ability to recapitalize their credit union.

Based on its review and analysis, the Working Group offers the following observations and conclusions:

1. Affording credit unions the ability to raise supplemental capital that counts towards PCA “net worth” requirements is an appropriate policy consideration;
2. PCA regulatory reform including a more robust risk-based capital system, as advanced by the NCUA Board in 2005 and 2007, should continue to be pursued as a priority. The reforms combined with supplemental capital could afford credit unions the opportunity to more effectively manage capital levels;
3. Any statutory change that affords credit unions the ability to count supplemental capital towards PCA “net worth” must be accompanied by robust regulatory authority to assure reasonable safeguards and risk parameters are put in place.
Section 1 | Background

A. Federally Insured Credit Unions’ Current Capital Accumulation Tools

Federal credit unions (FCU) became an important part of the nation’s financial system in 1934 with the enactment of the Federal Credit Union Act.\(^1\) Congress reaffirmed FCUs’ role in the American economy in 1998 with the enactment of the Credit Union Membership Access Act (CUMAA).\(^2\) CUMAA also mandated, for the first time, a system of prompt corrective action (PCA) for federally insured credit unions.\(^3\) The system was designed to ensure problems in federally insured credit unions are resolved at the least long-term cost to the National Credit Union Share Insurance Fund (NCUSIF), the fund backed by the full faith and credit of the United States government to insure member accounts in all federal credit unions and the substantial majority of state-chartered credit unions.

All credit unions rely almost exclusively on retained earnings to build capital. Two types of credit unions, low-income designated credit unions and corporate credit unions, are permitted forms of supplemental capital (also called “alternative capital,” “contributed capital,” or “secondary capital”).\(^4\) With the advent of PCA for credit unions, Congress limited the definition of “net worth” (the credit union version of regulatory capital) to retained earnings as defined by generally accepted accounting principles (GAAP). Thus, other forms of capital cannot legally be counted as “net worth” for federally insured, natural person credit unions other than those with a low-income designation. A change in the law would be required to permit all federally insured credit unions\(^5\) to count supplemental capital in PCA ratios. NCUA cannot count other sources of capital as “net worth” by regulation.

Supplemental capital instruments may only have value to federally insured credit unions if they are included in the PCA “net worth” calculation. The utility and appropriateness of having alternative sources of capital available to federally insured credit unions has been the subject of much research and debate within the credit union system. Credit unions are currently the only financial institutions within the U.S. financial system that do not have the authority to raise supplemental capital and have it count, from a statutory perspective, towards the institutions’ statutory capital requirement. Furthermore, internationally, many credit union systems utilize forms of supplemental capital.

The Federal Credit Union Act currently provides NCUA limited authority to establish supplemental capital that would benefit federally insured credit unions by enhancing their “net worth” for PCA purposes. Only low-income designated credit unions can offer supplemental capital (known as “uninsured secondary capital”) to nonmembers that counts toward PCA “net worth.”\(^6\) All other federally insured credit unions are limited to issuing subordinated debt, and, when authorized by state law, other uninsured share-like instruments, id. §12 U.S.C. 1757(9), none of which meet the PCA definition of “net worth,” id.

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3. Id. at §301, et seq. PCA consists of mandatory minimum capital standards indexed by a credit union’s “net worth ratio” to five statutory net worth categories. (12 U.S.C. 1790d; 12 C.F.R. part 702; 65 FR 8560 (Feb. 18, 2000). As a credit union’s net worth ratio falls, its classification among the net worth categories declines below “well capitalized,” thus exposing it to an expanding range of mandatory and discretionary supervisory actions designed to restore net worth. (E.g., 12 C.F.R. 702.201(a), 702.202(a), 702.204(b).
4. The NCUA Board is authorized by law to define “credit unions serving predominantly low-income members.” 12 U.S.C. 1757(6).
5. To be so designated by the appropriate Regional Director, the NCUA Board generally requires the majority of a credit union’s members to earn less than 80 percent of the average national wage as determined by the Bureau of Labor Statistics, or to have annual household incomes below 80 percent of the national median as determined by the Census Bureau. 12 C.F.R. 701.34(a)(2)–(3). Under the authority to charter central credit unions, 12 U.S.C. 1766(a)(1), the NCUA Board established a capital structure for corporate credit unions that consists of retained earnings plus “paid-in capital” and “membership capital” accounts (PIC and MCA, respectively). 12 C.F.R. §§704.2, 704.3(b) and (c). For additional discussion of corporate credit union capital, see page 9 below.
6. For purposes of this white paper, the terms “credit union” and “federally insured credit union” are interchangeable.
§1790d(o)(2)(A). From a capital standpoint, this leaves only a small subset of federally insured credit unions that would benefit from issuing supplemental capital. The only PCA benefit for non-low-income designated credit unions that issue supplemental capital is that, when “undercapitalized” or below and required to submit a Net Worth Restoration Plan for approval, id. §1790d(f)(1), NCUA “may consider the type and amount of any form of regulatory capital which may become established by NCUA regulation, or authorized by State law and recognized by NCUA, that the federally insured credit union holds,” even though it is not included in PCA “net worth.” 12 C.F.R. 702.206(e). However, the Federal Credit Union Act does not permit NCUA to adjust a federally insured credit union’s net worth ratio or increase its net worth classification to reflect the regulatory capital it holds, nor to exempt it from the “mandatory supervisory actions” that apply. 12 U.S.C. 1790d(f) and (g). Nor does it recognize supplemental capital as a permanent source of funding for non-low-income designated credit unions and still limits them to rebuilding their net worth through retained earnings.

**B. Supplemental Capital Research**

Since CUMAA, a variety of research papers and studies have been conducted discussing whether supplemental capital for credit unions is needed. In particular, The Filene Research Institute has issued seven studies since 2001 on credit union capital issues. These research papers range in topic from differences in bank and credit union capital needs to a review and extension of evidence regarding public policy reform on supplemental capital for U.S. credit unions.

In particular, these research efforts uniformly opine that U.S. credit union capital formation has lagged behind capital formation options for other institutions.

- Banks and thrifts in the United States and abroad enjoy much broader authority than U.S. credit unions to pursue alternative sources of capital. Similarly, non-U.S. credit unions and domestic and foreign financial cooperatives have many capital-raising options. Production, consumer, and other types of cooperatives throughout the developed world can access capital markets in a variety of ways.

- The unusual limitations on U.S. credit union capital formation powers raise questions about why these financial institutions are so restricted, and whether credit union members and the general public would be better serviced if U.S. credit unions had access to more capital formation options.

In 2004, the U.S. Government Accountability Office (GAO) issued its report GAO-04-849, *Credit Unions: Available Information Indicates No Compelling Need for Secondary Capital*. The report opined that the industry’s interest in making changes to the current capital requirements appeared to be driven by three primary concerns:

- Restricting the definition of net worth solely to retained earnings could trigger prompt corrective action (PCA) due to conditions beyond credit unions’ control;
- PCA, in its present form, acts as a restraint on credit union growth; and
- PCA tripwires, or triggers for corrective action, are too high given the conservative risk profile of most credit unions.

As intimated by the report’s title, GAO concluded that there was no evidence that “the inflow of member share deposits resulted in widespread net worth problems for federally insured credit unions during the period that PCA has been in place.” Moreover, the GAO opined that “[w]hile PCA is intended to curb aggressive growth,
our analysis of credit union and bank data indicates that credit unions have been able to grow at a higher rate than banks during the 3 years that PCA has been in place for credit unions.” Finally, the GAO indicated that the seminal issue of supplemental capital centers on who would purchase supplemental capital instruments:

Allowing investors outside the credit union industry to hold the instruments would bring increased market discipline, but there are concerns that this would be more costly than the usual sources of funds and change the member-owned, cooperative nature of the credit union industry. Alternatively, allowing investors from within the industry may alleviate these concerns; however, in-system investors could impose less discipline than out-of-system investors, raising concerns about investor protection – adequacy of disclosure regarding the uninsured, subordinated status of the investment – and the potential that a weaker credit union could pull down a stronger one (systemic risk) because of the investment of one credit union would be treated as the capital of another.10

In 2005, NASCUS issued its white paper, Alternative Capital for Credit Unions...Why Not?11 The paper presents three alternative capital models designed to preserve the not-for-profit, mutual, member-owned cooperative structure of credit unions and their current tax exempt status. The first two models discussed in the paper are equity capital instruments, “one that raises funds from members only, the other from nonmembers. Both of the models are ‘debt’ for federal income tax purposes, while being characterized as ‘equity’ under generally accepted accounting principles.”12 The third model is a subordinated debt model instrument that would be recognized by other federal financial regulators as Tier II capital.13

Since the issuance of many of these reports, and in particular, the GAO Report, the credit union system and financial marketplace have experienced significant changes. These changes and events are critical in assessing whether supplemental capital that counts towards PCA “net worth” requirements is an appropriate policy goal. In particular, the Working Group concluded the following changes and events are particularly relevant.

**PCA Reform Proposals**

Two PCA regulatory reform proposals have been advanced by NCUA since the 2004 GAO Study.14 These proposals address the needs for a more robust risk-based capital system and resolve several of the concerns of the credit union system relative to capital requirements and the adverse impact from PCA. Currently, the proposals incorporate a lower leverage ratio requirement with a more robust risk-based capital standard which will be the actual measurement for nearly two-thirds of all credit unions. This puts additional emphasis on credit unions understanding and measuring the risk of activities, services, or operations in relation to their capital level.

The Working Group believes that if PCA regulatory reform could be achieved, it would significantly enhance the credit union systems’ ability to effectively manage capital. In accordance with the proposals, the Working Group maintains that the current PCA statutory requirements for credit unions are too rigid and establish a structure based primarily on a “one-size-fits all” approach, which creates inequities for credit unions with low-risk balance sheets, limits NCUA’s ability to have a more relevant risk-based requirement and fosters accumulation of capital levels in excess of what is needed for most credit unions’ safety and soundness and strategic needs.

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9 Id.
10 Id. at 4.
11 National Association of State Credit Union Supervisors. Alternative Capital for Credit Unions...Why Not? (Summer 2005), p. 4.
12 Id. at 4.
13 See Section “D.” at page 10 below.
In addition, an area that could be further explored is the ability to use supplemental capital to help fund the increased capital requirements from the risk-based capital calculation. The Working Group believes that an effort to effectuate the two PCA regulatory reform proposals previously advanced would be beneficial in the overall effective management of credit union capital.

**Current Economic Climate**

**Discouraging Member Deposits**

A fair number of credit unions paying lower than average dividends are experiencing high levels of share growth and dilution of their net worth ratios. The current economic climate has revealed that some well-capitalized credit unions are discouraging consumer deposits because of a potentially negative impact on PCA capital levels. In essence, credit unions are forced to control growth and expansion due to the limitations on raising immediate capital, in this case, by discouraging member deposits. The fear of PCA is resulting in institutions taking actions resulting in short-term improvements to the net worth ratio at the expense of the long-term benefit of increased member participation.

NCUA has proposed two narrow legislative remedies that would help reverse the disincentive to accept new share deposits: (1) A change in the “total assets” denominator of the net worth ratio that would allow qualifying credit unions to exclude those assets that have a zero risk weighting (such as short-term U.S. Treasury securities), exposing the credit union to virtually no risk of loss. Strict regulatory standards would be imposed so that only credit unions above a certain net worth standard would be eligible, and any observed decline in net worth was attributable to growth in shares (deposits), not poor management or unsafe, unsound activities; and (2) Authorization for qualifying credit unions to issue alternative forms of capital to supplement their retained earnings. To ensure the proper authority, alternative forms of capital would be subject to necessary regulations addressing safety and soundness criteria, investor protections, and any impact on the cooperative credit union governance model.

**Bridging the Gap**

Since the issuance of the GAO Report, net worth has risen from 10.96% as of December 31, 2004 to a high of 11.53% as of December 31, 2006. Since 2006, net worth has slowly declined and stands at 9.91% as of December 31, 2009. There is no indication that the trend in declining net worth will abate in the foreseeable future. Current trends raise questions as to how credit unions will sustain growth with a retained earnings capital framework. Many credit unions are exposed to loan losses in markets experiencing job losses and house price declines. In addition, pressures on earnings due to thin margins could continue for some time going forward (e.g., low rate environment). Hence, being limited to building net worth only through retained earnings could create capital management problems for many credit unions in the future. Subject to market viability, supplemental capital might enable credit unions to stabilize their net worth positions now, and speed the pace of net worth accumulation going forward. By maintaining adequate levels of capital from various sources, credit unions would be able to continue to provide member services (e.g., lending), serving the needs of consumers and small businesses and supporting economic recovery.

16 During an economic crisis and associated “flight to quality,” options for raising at-risk capital in the market are generally very limited. A credit union that was experiencing a deteriorating financial condition would have difficulty raising supplemental capital. If a credit union had previously raised supplemental capital, the costs associated with this type of capital would squeeze earnings, even more, putting more pressure on a credit union to potentially take more risk in an effort to generate revenue. In addition, as an investor protection, credit unions already in danger of failing would not be allowed to offer supplemental capital.
Supplemental capital could help bridge the gap between efficient use of resources and prudent capital reserves (i.e., reduce the incentive to hold unnecessary high levels of capital). That said, the amount of net worth in excess of 7% of assets is $25.8 billion (total 12/31/09 net worth of $87.7 billion less $61.9 billion at 7% of assets). It would take growth of 40% in assets with no increase in aggregate net worth to reduce net worth to 7%. The Working Group recognizes that these are aggregate numbers and that individual credit unions may be in very different positions.

The severe economic downturn, and current financial and mortgage market crisis have exposed all types of financial institutions to unexpected risks and caused an economy-wide dislocation. This raises questions of how credit unions could raise supplemental capital during an economic downturn given the wariness of potential investors. However, supplemental capital, in place prior to a crisis, could provide a mechanism for members with confidence in their credit union to provide support during a downturn, and could possibly facilitate a credit union’s participation in a recovery after a downturn. In addition, the evolution of financial products and services continues to accelerate and credit unions should have the ability to evolve to stay competitive. Access to supplemental capital could potentially enhance a credit union’s ability to more timely implement products and services to stay competitive.

Systemic Risk Considerations

Some credit unions are taking additional risk in their balance sheet structure and product offerings, and at times do so without proper due diligence prior to implementing the product or service. Requiring capital accumulation through retained earnings does provide a “cushion” to the level of risk-taking to which a credit union can safely engage. While supplemental capital can increase that “cushion” for risk-taking, it cannot supplant the due diligence necessary to grow safely and soundly.

A series of credit union failures over the past three years have shown the potential adverse impact from credit unions investing in the loans or activities of each other. A supplemental capital structure which allows for investment between credit unions has the potential for increasing systemic risk within the credit union industry without actually producing new capital to buffer losses. The result is increased risk exposure to the NCUSIF without a corresponding increase in new capital.

Investments in Corporate Credit Unions

The investment by credit unions in supplemental capital instruments of corporate credit unions illustrates the potential for material investor misunderstanding of the risks inherent in the capital. During the current economic downturn, corporate credit unions have needed to absorb the secondary capital of investing credit unions. While the presence of supplemental capital in individual corporates benefited the NCUSIF by absorbing losses and helping preserve the individual credit union, there have been numerous questions and concerns raised about the fairness of the decisions made to use the capital to cover losses, as well as a lack of full understanding of the risk taken when the investments in the capital instruments were made by these institutional investors. This raises additional concern about the understanding and expectations of a credit union member who would be investing in the capital instruments. Particular regulatory attention should be given to both investor suitability standards and comprehensive disclosures.

C. Other Models

Since 1998, financial institutions, including credit unions, in most countries have been subject to the international capital standards established by the BASEL accords, commonly known as BASEL I. The framework for BASEL II was released in 2004.\textsuperscript{17} The BASEL capital standards primarily address credit and

operational risk, define Tier 1 and Tier 2 capital instruments and risk assets, and require total capital to be at least 8% of risk-weighted assets. Other than credit unions, federally insured financial institutions in the United States follow the BASEL standards for their risk-based capital standards.

Federally insured financial institutions in the U.S. also are subject to a capital to total assets requirement, commonly referred to as a leverage ratio. To be well capitalized, institutions insured by the Federal Deposit Insurance Corporation (FDIC), by regulation, must maintain a leverage ratio of at least 5%. Only Tier 1 capital instruments are included in the leverage ratio.

Federally insured credit unions are subject to a statutory leverage ratio (called the “net worth ratio”) requirement of 7% to be well capitalized. Risk-based capital requirements for federally insured credit unions do not follow the BASEL accords as by statute they must be more inclusive of the types of risk (e.g., interest rate risk) and are limited to a very small subset of credit unions defined as “complex.”

**Tier 1 vs. Tier 2 Capital**

Credit unions are not currently under a tiered capital system. For federally insured credit unions, what counts as capital (i.e., net worth) is largely limited to retained earnings. Tiered capital requirements for banks are as follows:

<table>
<thead>
<tr>
<th>Tier</th>
<th>Capital Requirement</th>
<th>Qualifying Instruments</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>5% of total assets(^{20}) and 6% of risk assets</td>
<td>Retained earnings, common stock, and perpetual preferred common stock. Though the Federal Reserve Board allows up to 25% (15% for internationally active banks as limited by BASEL) for Trust Preferred Securities (TPS), FDIC allows none.</td>
</tr>
<tr>
<td>II</td>
<td>10% of risk assets</td>
<td>Tier 1 capital plus: &lt;ul&gt;&lt;li&gt;Available for Sale (AFS).(^{21})&lt;/li&gt;&lt;li&gt;Allowance for Loan and Lease Losses (ALLL) (up to 1.25%), most other preferred stock, and hybrids – total of all limited to 100% of Tier&lt;/li&gt;&lt;li&gt;Intermediate (5+ year) preferred stock and term (5+ year) subordinated debt – total of all limited to 50% of Tier 1.(^{22})&lt;/li&gt;&lt;/ul&gt;</td>
</tr>
</tbody>
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\(^{18}\) Some country specific adjustments are made for FDIC insured institutions. In addition, 8% is the standard for Adequately Capitalized under FDIC’s Prompt Corrective Action system, with 10% the standard for well capitalized.

\(^{19}\) Low-income designated credit unions count secondary capital. This also includes provision for pre-merger retained earnings from assumed institutions.

\(^{20}\) For banks, this is commonly referred to as the leverage requirement or leverage ratio, and is comparable to the net worth ratio for credit unions. 12 U.S.C. 1831o(c); 12 C.F.R. 325.2(k), 325.103(a)(3).

\(^{21}\) See 12 C.F.R. 325, Appendix A, Section I.A.2.(f). Up to 45% of pretax, net unrealized holding gains (that is, the excess, if any, of the fair value over historical cost) on available-for-sale equity securities with readily determinable fair values may be included in supplementary capital. However, the FDIC may exclude all or a portion of these unrealized gains from Tier 2 capital if the FDIC determines that the equity securities are not prudently valued. Unrealized gains (losses) on other types of assets, such as bank premises and available-for-sale debt securities, are not included in supplementary capital, but the FDIC may take these unrealized gains (losses) into account as additional factors when assessing a bank’s overall capital adequacy.

\(^{22}\) This has the effect of drawing down total capital at an accelerated, i.e., 150%, rate. For example, if a credit union has 4% Tier 1 capital and 2% supplemental capital, a diminution in 1% of Tier 1 capital (to 3%) results in a limit of 1.5% for Tier 2 capital. Thus, a credit union could go from a total capital ratio of 6% to 4.5% with only a 1% decline in Tier 1 capital.
Almost all the instruments that credit unions could use as supplemental capital only qualify as Tier II capital, which is held to a higher capital requirement (10%) and not comparable to NCUA’s net worth ratio. Thus, to maintain consistency, any instruments that did not qualify as Tier 1 would only qualify for a credit union capital standard above the current 7%.

Banks have additional incentives to use these hybrid forms of capital given the tax advantage and the advantage of preventing the dilution of ownership, neither of which applies to credit unions generally. The net cost of servicing supplemental capital is much higher for a non-profit or not-for-profit.

In addition to models within the U.S. financial services arena, financial cooperatives and credit unions in other countries are permitted broader capital formation options than currently are available to U.S. credit unions. The Filene Research Institute’s 2006 report, Capital Acquisition in North American and European Cooperatives, by Dr. Michael L. Cook and Dr. Fabio R. Chaddad, provides an extensive comparison on how cooperative organizations, particularly agricultural cooperatives in the U.S. and overseas, raise capital. Underlying the analysis of other cooperative models is the “variety and range of robust capital formation tools at the disposal of most cooperatively held organizations.”

D. NCUA’s Supervisory Experience With Supplemental Capital

NCUA already has experience with certain forms of supplemental capital. Currently, both low-income designated credit unions and corporate credit unions are permitted to raise certain forms of supplemental capital.

**Low-income Designated Credit Unions**

Under conditions prescribed by the NCUA Board, credit unions serving predominantly low-income members are permitted by law to receive payments on shares from non-natural persons. In 1996, the NCUA Board authorized low-income designated credit unions, including state-chartered credit unions to the extent permitted by state law, to accept uninsured secondary capital from non-natural person members and nonmembers. The purpose of uninsured secondary capital is to provide a further means – beyond setting aside a portion of earnings – for low-income designated credit unions to build capital to support greater lending and financial services in their communities, and to absorb losses and thus protect them from failing. Before accepting uninsured secondary capital, a low-income designated credit union must submit a written plan for the use and repayment of the uninsured secondary capital. Uninsured secondary capital accounts must have a minimum maturity of five years and may not be redeemable prior to maturity. The accounts must be established as uninsured, non-share instruments. Most importantly, uninsured secondary capital funds on deposit (including interest paid into the account) must be available to cover operating losses in excess of the low-income designated credit union’s net available reserves and undivided earnings. Additionally, funds used to cover such losses may not be replenished or restored to the uninsured secondary capital accounts.

Since the inception of uninsured secondary capital, NCUA’s regulations have required low-income designated credit unions to discount an uninsured secondary capital account’s original capital value (now called “net worth value” under PCA) – essentially recategorizing the discounted portion as subordinated debt – in 20% annual

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23 Filene Research Institute, Capital Acquisition in North American and European Cooperatives, by Dr. Michael L. Cook, Robert D. Partridge Endowed Professor, Applied Social Science Divisions, CAFNR, at the University of Missouri - Columbia and Dr. Fabio R. Chaddad, Professor of Strategy at the IBMEC Business School, Sao Paulo, Brazil, p. 3.
25 12 C.F.R. 701.34(b).
26 Id. at (b)(1).
27 Id. at (b)(3) and (4).
28 Id. at (b)(2) and (5).
29 Id. at (b)(7).
increments beginning at five years remaining maturity.\textsuperscript{30} Even as its capital value is discounted, however, the full amount of uninsured secondary capital must remain on deposit to cover losses.\textsuperscript{31}

December 31, 2009 NCUA call report data shows that of the 1,102 low-income designated credit unions, 41 are reporting secondary capital accounts totaling $82 million. Of the 41 low-income designated credit unions reporting secondary capital accounts, 29 are “well capitalized” under PCA and 5 are “adequately capitalized.” This means 83\% of the low-income designated credit unions with secondary capital are subject to little or no PCA provisions. This compares to 97\% of the general credit union population that is subject to little or no PCA provisions.\textsuperscript{32}

NCUA’s supervisory experience with uninsured secondary capital in low-income credit unions has been mixed. As recently as 2006, NCUA addressed a pattern of lenient practices in some low-income designated credit unions that frustrate the good faith use of uninsured secondary capital. These included: (1) poor due diligence and strategic planning in connection with establishing and expanding member service programs such as ATMs, share drafts and lending (e.g., member business loans, real estate and subprime); (2) failure to adequately perform a prospective cost/benefit analysis of these programs to assess such factors as market demand and economies of scale; (3) premature and excessively ambitious concentrations of uninsured secondary capital to support unproven or poorly performing programs; and (4) failure to realistically assess and timely curtail programs that, in the face of mounting losses, are not meeting expectations. These experiences among low-income designated credit unions that accept secondary capital show the danger and consequences of leverage when used by institutions that do not conduct the necessary planning and risk management required to effectively utilize the extra leverage provided by supplemental capital. Lenient practices of this kind contribute to excessive net operating costs, high losses from loan defaults, and a shortfall in revenues (due to non-performing loans and poorly performing programs), all of which result in lower than expected returns.\textsuperscript{33} More importantly, the philanthropic incentives for supplemental capital investors in low-income designated credit unions will likely not apply to all other natural person credit unions, increasing the cost and challenges in administration. Supplemental capital makes sense only in institutions where such conditions do not persist and as part of a carefully considered long-range business strategy.

**Corporate Credit Unions**

The Federal Credit Union Act authorizes the NCUA Board to charter central credit unions, also known as corporate credit unions.\textsuperscript{34} Under that authority, the NCUA Board established a capital structure for corporate credit unions that consists of retained earnings plus “paid-in capital” and “membership capital” accounts (PIC and MCA, respectively).\textsuperscript{35} The essential features of PIC are that it must be uninsured, have perpetual maturity, and be “available to cover losses that exceed retained earnings.”\textsuperscript{36} The essential features of MCA are that it must be uninsured, have a minimum maturity of three years, and be “available to cover losses that exceed retained earnings and PIC.”\textsuperscript{37} The essential features of PIC and MCA must be recited in the initial offering disclosures for both, and in annual disclosures to MCA holders.\textsuperscript{38}

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\textsuperscript{30} Id. at (c)(1).  
\textsuperscript{31} Id. at (c)(2).  
\textsuperscript{32} All federally insured credit unions report financial information to NCUA quarterly. Financial Performance Reports for individual credit unions or groups of credit unions can be accessed by the public at: [http://webapps.ncua.gov/ncuafpr](http://webapps.ncua.gov/ncuafpr).  
\textsuperscript{33} 71 FR 4234, 4236-4237 (Jan. 26, 2006).  
\textsuperscript{34} 12 U.S.C. 1766(a)(1).  
\textsuperscript{35} 12 C.F.R. §§704.2, 704.3(b) and (c).  
\textsuperscript{36} Id. at §§704.2, 704.3(c)(4).  
\textsuperscript{37} Id. §§704.2, 704.3(b)(6).  
\textsuperscript{38} Appendix A to Part 704.
The result is that PIC is permanent and subject to depletion ahead of MCA; MCA is redeemable upon three years’ notice, but until the date it is redeemed, remains available to be depleted if a retained earnings deficit still exists after PIC is exhausted. To the extent PIC and MCA accounts are exhausted, they are not entitled to earn dividends otherwise payable on outstanding PIC and MCA. Consistent with the fundamental purpose of capital — to serve as an additional reserve to absorb losses — a corporate credit union has no legal obligation as a going concern to replenish depleted PIC and MCA out of future retained earnings. Once a corporate credit union is liquidated, however, depleted capital holders may assert a claim for their losses against the liquidation estate of the credit union.

Over the last 12 months, NCUA has witnessed the depletion of PIC and MCA to cover losses incurred by corporate credit unions. In March 2009, two corporate credit unions, U.S. Central Federal Credit Union (U.S. Central) and Western Corporate Federal Credit Union (WesCorp), were forced to recognize extraordinary losses in the value of mortgage-backed securities held in their investment portfolios. In the case of U.S. Central, the retained earnings deficit created by these losses caused the exhaustion of all members’ PIC and MCA accounts as of 12/31/09. In the case of WesCorp, the retained earnings deficit created by its losses on mortgage-backed securities caused the complete exhaustion of both member PIC and MCA accounts, rendering WesCorp insolvent were it not for the NCUA Board’s authorization to operate with a “prior undivided earnings deficit.” From a regulatory perspective, the capital reserves served their function by absorbing losses and preserving the institutions. These experiences underscore a key concern the Working Group has about supplemental capital — that the industry demonstrated a strong unwillingness to use capital as a reserve of funds to manage the risk of the institutions and absorb losses. These experiences substantiate the lack of understanding amongst credit unions about the function of capital and are troubling when contemplating the authorization of a form of leverage (supplemental capital) that may have less discipline than retained earnings.

While NCUA’s supervisory experience with supplemental capital in low-income credit unions and corporate credit unions has been mixed, the experience serves to highlight and underscore the key policy considerations outlined in the next section.

39 Id. §§704.3(b)(3).
40 Id. §§709.5(b)(7) and (b)(9), 704.3(b)(3) and (c)(4).
41 Both corporate credit unions were placed into conservatorship by the NCUA Board on March 20, 2009. To ensure that membership in each credit union was not affected by depletion of its PIC and MCA below the minimum level required to maintain membership, the conservator waived each credit union’s bylaw requirement to maintain a prescribed level of MCA in order to continue membership.
Section 2 | Public Policy Considerations and Key Principles

A. Safety and Soundness

There are a variety of public policy considerations when evaluating supplemental capital for credit unions. These include evaluating the importance of maintaining mutuality at credit unions and consumer protection issues. However, for NCUA, one of the top considerations must always be to limit the losses to the NCUSIF, or, put another way, safety and soundness.

Supplemental capital can mitigate insurance fund losses upon failure. It may shorten recovery from losses caused by uncontrolled external factors (i.e., flights to safety, natural disasters, and local market declines). Currently, credit union strategies for recovery are limited to shrinking assets to achieve improved net worth ratios, reductions of share dividend rates, raising loan rates, increasing fees, cutting operating expenses, selling assets, and merging the credit union—all of which have a negative member and community consequence.

However, the argument that supplemental capital will minimize losses to the NCUSIF has certain limitations. Even though supplemental capital can provide more protection to the NCUSIF to the extent it increases total capital (i.e., not merely exchanged for a portion of retained earnings resulting in no net increase to total capital), supplemental capital can increase the risk of failure for institutions and create systemic (reputation) risk. Supplemental capital with its associated high cost leads to pressure on earnings, potentially providing incentive to engage in high risk, high return activities. It may be used to sustain poorly conceived business models or excessive growth. Moreover, capital is a lagging indicator, with effective risk management dependent on asset quality and earnings. It is important to remember that capital is a regulatory construct. GAAP does not define capital; rather it defines equity. Some of the components of GAAP equity do not have a direct correlation to payout priorities for the insurance fund, and thus do not serve as protection for the NCUSIF. Because of accounting rules, all elements of GAAP equity do not have the degree of permanence and economic value necessary to provide real protection for the NCUSIF. This is why what constitutes capital is defined by the insurer.

Supplemental capital cannot function as effectively as retained earnings. There is no other form of capital that participates in losses ahead of retained earnings. Retained earnings are the first line of defense against losses and provide the management of the institution with the most flexibility and control. The discipline for using capital to manage risk is extremely important and an institution has to be careful not to place too much reliance on a source of capital that does not want to serve its true functional purpose. In addition, once retained earnings are exhausted and supplemental capital has to be charged for losses, the investors may attempt to invoke any default provisions or litigate to protect their remaining interests. This would complicate NCUA’s resolution efforts.

While supplemental capital can provide more protection to the NCUSIF to the extent it increases total capital, the use of supplemental capital is not without risks. These risks are also not unique to the use of supplemental capital. The need to generate retained earnings sufficient to support credit union growth can likewise provide incentive to engage in high risk activity. Neither high retained earnings net worth levels, nor supplemental capital, is a substitute for credit unions operating safely and soundly as the best protection for the NCUSIF.

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GAAP equity is defined by the Financial Accounting Standards Board (the “FASB”) while regulatory capital is defined by Congress in the Federal Credit Union Act (the “FCUA”) and by the NCUA Board when implementing regulation(s). For natural person credit unions, GAAP equity is generally comprised of Retained Earnings, items of Other Comprehensive Income, and Equity Acquired in a Business Combination. Regulatory capital is more narrowly defined by the FCUA as Retained Earnings as determined under GAAP, secondary capital for low income credit unions (which is a regulatory construct and a form of GAAP liability), and the Retained Earnings of any credit union with which the reporting credit union has combined (not a GAAP component).
B. Observations on the Effect of the Current Economic Crisis on Capital

In addition to public policy consideration of minimizing losses to the NCUSIF, the Working Group reviewed a recent U.S. Department of the Treasury white paper entitled Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms. The white paper enunciates important observations on the effect of the current economic crisis on capital at banking firms. These observations are instructive in enumerating other public policy considerations particularly regarding how supplemental capital could be utilized by credit unions in times of crisis. The Treasury white paper states:

A principal lesson of the recent crisis is that stronger, higher capital requirements for banking firms are absolutely essential. At the same time, we recognize that stricter capital requirements for banking firms are not without cost. Stricter capital requirements generally will reduce the amount of financial intermediation and may limit credit availability. The objective in designing a regulatory capital regime should be to maximize the prospects for financial stability without unduly curtailing credit availability, financial innovation, economic growth, or the ability of banking firms to attract private investment.

The white paper outlines eight core principles regarding capital for banking firms:

**Core Principle #1:** Capital requirements should be designed to protect the stability of the financial system (as well as the solvency of individual banking firms).

**Core Principle #2:** Capital requirements for all banking firms should be higher, and capital requirements for Tier 1 financial holding companies should be higher than capital requirements for other banking firms.

**Core Principle #3:** The regulatory capital framework should put greater emphasis on higher quality forms of capital.

**Core Principle #4:** Risk-based capital requirements should be a function of the relative risk of a banking firm’s exposures, and risk-based capital ratios should better reflect a banking firm’s current financial condition.

**Core Principle #5:** The procyclicality of the regulatory capital and accounting regimes should be reduced and consideration should be given to introducing countercyclical elements into the regulatory capital regime.

**Core Principle #6:** Banking firms should be subject to a simple, non-risk-based leverage constraint.

**Core Principle #7:** Banking firms should be subject to a conservative, explicit liquidity standard.

**Core Principle #8:** Stricter capital requirements for the banking system should not result in the re-emergence of an under-regulated non-bank financial sector that poses a threat to financial stability.

The Working Group found Core Principles 1-5 particularly compelling in considering supplemental capital for credit unions that would count towards PCA “net worth.” As noted earlier, the Working Group supports a robust, statutorily mandated PCA system that fosters healthy capitalization levels and effective capital management in federally insured credit unions. The two PCA reform proposals advanced by NCUA support Core Principles 1 through 4 cited above.

Core Principle #5 reflects a concern that the Working Group discussed and continues to have regarding raising supplemental capital during the current crisis. Generally, supplemental capital cannot be raised during major

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44 Id.
45 Allowing supplemental capital for credit unions may seem counter to this principle (i.e., putting greater emphasis on higher quality forms of capital). However, credit unions are already required to have all of their capital made up of the highest form, retained earnings. Hence, allowing a limited measure of supplemental capital for credit unions would still be consistent with having a high degree of emphasis on the highest quality forms of capital.
economic downturns. While troubled institutions are in most need of additional forms of capital to stabilize declining net worth, supplemental capital is either unavailable or cost prohibitive for such institutions. Supplemental capital must be issued in advance of when it is needed. It cannot be reactionary. For problems with the overall economy, the prescience that would be necessary to issue supplemental capital prior to the downturn does not exist. No one can truly predict the emergence or severity of widespread economic problems.

The Working Group felt it was critical to fully consider the necessary safeguards and potential unintended consequences of supplemental capital from a public policy perspective. Specifically, some credit unions currently in danger of failing may believe supplemental capital is the solution to their survival, even though the institution is unlikely to find willing investors, and regulators would not approve of such offerings given the credit union’s pending losses. The efficacy of supplemental capital depends upon a well-considered and prudent business strategy for how additional leverage will be employed, a full realization of the consequences for business decisions that go awry, and a better than average risk management culture and process that is willing to use capital as necessary. It is not dependent upon optimistic marketing, aggressive growth strategies or an appetite for high risk. Supplemental capital may create the real risk of a systemic crisis of confidence and runs impacting liquidity if members of even a relatively small subset of credit unions were to lose their at risk supplemental capital investments. Consumer confidence is needed during periods of economic instability; otherwise, the financial institution risks liquidity shortages caused by withdrawals stemming from the loss of confidence. Having members realize losses on their capital investments during a period of economic distress could create a run on liquidity since the members most likely to invest in secondary capital instruments are larger accountholders.

C. Three Key Principles

In reviewing the public policy considerations, conducting its research and speaking with colleague regulators at both the state and international level, the Working Group concluded there are three key principles applicable to any form of supplemental capital that credit unions may be authorized to issue by Congress which would count towards PCA “net worth” requirements. The three principles are:

1. Preservation of the cooperative mutual credit union model;
2. Robust investor safeguards; and
3. Prudential safety and soundness requirements.

Each principle is discussed below.

1. Preservation of the Cooperative Mutual Model

Credit unions represent a unique financial institution model within the larger U.S. financial services marketplace. A fundamental premise to the allowance of supplemental capital for credit unions is preserving the cooperative, mutual nature of credit unions.

Credit unions are owned by their members, are not-for-profit, and are generally run by a volunteer board of directors. The primary mission of credit unions is to serve their members, rather than assuring shareholder

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46 Some credit unions have expressed concern that supplemental capital could take a lot of political capital to achieve and come with other risks to all credit unions (e.g., taxation), while only benefiting a small number of primarily larger credit unions.

47 Policy makers also need to carefully consider the appropriate timing of granting any such supplemental capital authority. Shifting risk to the consumer in the midst of the current economic crisis with the associated pending losses could be perceived as the government taking advantage of individuals to protect the federal insurance fund. Timing is an important consideration given that upon implementation risk will start to be reassigned to members, potentially very disproportionately, and the members are not as well equipped to understand, monitor, and manage the risk as the regulator/insurer.
profit as in other models. Time and time again, Congress has reaffirmed the unique structure and mission of credit unions when it has amended the Federal Credit Union Act.48

Allowing credit unions to offer supplemental capital should be evaluated in the context of how it affects the governance and ownership of the cooperative model. In particular, while the Working Group believes that there is an appropriate role for subordinated debt from institutional investors, regardless of whether they be members of the credit union or external investors, in credit unions’ regulatory capital scheme (i.e., limited to inclusion in the risk-based net worth ratio), supplemental capital instruments that closely mirror equity investments should be reserved for members. This framework aligns with the other capital models in the U.S. financial services system and would offer credit unions some flexibility in raising supplemental capital.49

2. Robust Investor Safeguards

Another key principle is assuring that investors are protected, to the extent possible, by robust, transparent and full disclosures.

Fundamentally, supplemental capital differs from a credit union share account because shares are insured up to the current Standard Maximum Share Insurance Amount (SMSIA) of $250,000.50 Supplemental capital would be uninsured and therefore available to cover losses directly after depleting retained earnings. For credit union members, this is a vastly different proposition than depositing funds into a credit union with the knowledge that the deposit is backed by the full faith and credit union of the United States government.51

Moreover, as the current economic crisis has demonstrated, individuals need to have clear, appropriate disclosures about the products and services they are receiving from a financial institution. If supplemental capital is allowed for credit unions, the Working Group believes it is imperative to require disclosures that will, to the extent possible, maximize members’ understanding of the risks, mechanics and limitations of supplemental capital accounts. To that end, the Working Group proposes that consumer protection measures be incorporated by statute or regulation to benefit the supplemental capital investor, including:

- Affirmative suitability determination requirements and clear and robust disclosure of the terms and risks of the supplemental capital instrument to ensure that the investor is fully-informed, including periodic reminders that a supplemental capital account is uninsured, will be applied to absorb losses to the extent they exceed retained earnings, and will not be replenished in that event.52 As part of the disclosures and safeguards for investors (see VPC accounts in the Possible Models for Supplemental Capital section) credit unions must:

49 To the extent supplemental capital equates to equity under GAAP, the more comfortable external parties will be with its inclusion as regulatory capital. Conversely, supplemental capital that equates to a liability under GAAP is less likely to be viewed by external parties as capital instruments. Credit union board intervention to convert the liability instrument to an equity instrument will have implications for the credit union in terms of reconsidering whether or not the credit union is a variable interest entity and who among the involved parties (equity holders) may hold the primary beneficial interest in the variable interest entity that precipitates consolidation accounting.
50 12 C.F.R. 745.1(e) (2009); 74 FR 55747 (Oct. 29, 2009).
51 In terms of member disclosure and understanding, a potential complicating factor for credit unions is that savings accounts are called “share accounts,” and certificate of deposit accounts are called “share certificates.” Investments made by members in any at risk capital accounts should not be characterized as any form of share account to avoid confusion about the nature of the account and its federally insured status. In addition, there is always the potential for confusion with the common understanding of buying “shares” as referring to stock in a stockholder based institution.
52 When used to absorb a loss (loss defined as an expense in the reporting period per generally accepted accounting principles), it cannot ever be recovered under any circumstances, even if the credit union recovers some or all of the loss.
– Provide a prospectus clearly articulating the risks, including providing peer financial performance comparison data and federally insured credit union failure history over the relevant time horizon (20 or more years).

– Receive affirmative written acknowledgment from the member of receipt of the uninsured and risk disclosures, and maintain these signed disclosures for the prescribed retention period.

– Provide the investor a copy of the most recent independent CPA opinion audit and credit union financial statements.

• Subjecting credit unions and their employees to administrative enforcement sanctions for the failure to carry out the affirmative disclosure and investor suitability obligations.

• Requiring credit unions to be at least adequately capitalized per PCA standards, and have at least 4% of retained earnings to total assets at the time of issuance (see VPC accounts in the Possible Models for Supplemental Capital section). This ensures a sufficient buffer of retained earnings to protect the investor and to mitigate reputation and financial risks at issuance.

• Requiring credit unions to receive an annual (see VPC accounts in the Possible Models for Supplemental Capital section) independent CPA opinion audit. This ensures transparency in financial reporting.

• Requiring credit unions to comply with disclosure and transparency standards (e.g., executive compensation) comparable to publicly owned institutions.

• Requiring credit unions to receive prior approval of the regulator. The regulator must determine for the written record that the credit union is not in danger of failure in the foreseeable future (e.g., 18 months) and the credit union’s plans for issuing the VPC meet all investor disclosure and suitability requirements.

• Requiring credit unions to offer supplemental capital only to members that have belonged to the credit union for at least one year (see VPC accounts in the Possible Models for Supplemental Capital section). In addition, individuals would be limited to a minimum investment of $10,000 and a maximum of 15% of the daily average total shares held on deposit over the preceding 12 months. These provisions help ensure some measure of financial sophistication and wherewithal to absorb the loss of the member.

• Requiring a uniform maximum par value of $50 per share (see Mandatory Membership Capital in the Possible Models for Supplemental Capital section) in order to preserve membership availability for people of modest means.

During the dialogue on this issue, the Working Group debated whether NCUA would be the appropriate entity to regulate such disclosures and investor suitability standards. There is the real potential in a credit union failure involving supplemental capital for accusations of a conflict of interest between the safety and soundness regulator in the role of safeguarding the insurance fund and in establishing and enforcing the investor protection disclosure requirements. It is important to take into account these potential conflicts when determining how these disclosure standards should be developed and enforced. Note that no such conflict exists for state regulators with respect to their state-chartered credit unions.

53 Given the systemic nature of the reputation risk involved, the interests of consumer protection and the risks to the share insurance fund are relatively well aligned.

54 Department of Finance Canada. *Guidelines on Offering Statements for Credit Unions and Caisses Populaires* (March 1, 1995), Section A.
3. Prudential Safety and Soundness Requirements

Though supplemental capital may add protection for the NCUSIF,\(^{55}\) supplemental capital used inappropriately can create safety and soundness problems. The safety and soundness provisions that need to be in force for all forms of supplemental capital include the following (see the Possible Models for Supplemental Capital section for safety and soundness provisions specific to each form of supplemental capital):

- There must be a sufficient degree of permanence to warrant treatment as capital:
  - To count in the net worth (leverage) ratio, any supplemental capital instrument would need to be equivalent to what is considered Tier 1 capital under FDIC rules and BASEL (i.e., perpetual, non-cumulative).
  - Tier II equivalents should only count toward the risk-based net worth requirement, limited in total to no more than 50% of retained earnings, and held to a standard higher than the leverage ratio (e.g., 8% under BASEL to be adequately capitalized).
  - When any supplemental capital’s remaining maturity (or any redemption notice period is invoked) falls below 5 years, it becomes a Tier II instrument and its capital treatment must be reduced by 20% for each year below 5 years of remaining maturity.
- Consolidations and regulatory actions cannot trigger calls/default.
- Supplemental capital must be available to absorb losses while the credit union is a going concern. For a going concern, losses would be defined as those reported under GAAP. However, unforeseen events such as those involving fraud could necessitate regulatory action that includes applying the capital against a loss that has not yet been reported on the financial statement of a credit union. These situations usually result in the liquidation of the credit union, and as such, the credit union would no longer be a going concern.\(^{56}\)
- Any early redemption by a credit union of supplemental capital (e.g., to reduce borrowing cost if capital is no longer needed) must be subject to approval by both NCUA as insurer and the primary state regulator, if applicable. This prevents collusion between the credit union and investor, or sympathy for the member, allowing exodus of capital when it may be needed to protect the NCUSIF.
- Supplemental capital cannot be coincident with a lending transaction of the credit union (e.g., the credit union cannot finance a member’s purchase of their capital instrument), and cannot be pledged as collateral for a loan. This ensures the capital is legitimate.
- Prior regulatory approval should be given before a credit union can offer supplemental capital and supplemental capital should not be offered when a credit union is in danger of liquidation in the foreseeable future (e.g., 18 months) or under stress.

After agreeing on these key principles, the Working Group set out to develop possible models for supplemental capital that would adhere, as closely as possible, to the principles. The next section addresses the three models the Working Group discussed.

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\(^{55}\) Supplemental capital only provides additional protection to the NCUSIF to the extent it increases total capital. If it is merely used to swap out some portion of retained earnings, it would not increase total capital and in fact lower the overall quality of capital, and thus increase risk.

\(^{56}\) Claims for loss could only occur in liquidation provided cause of action occurred within 365 days preceding date of liquidation. Payout priority in liquidation would be: NCUSIF and uninsured shares, SD, MMC, and finally VPC.
Section 3 | Possible Models for Supplemental Capital

The Working Group reviewed various approaches to supplemental capital instruments that could be adapted for federally insured credit unions in the United States to meet the key public policy principles outlined above. Essentially all models break down along two lines:

1. Source of the supplemental capital – members (as owners in the cooperative model) versus external investors. An important consideration for each source is whether or not the investor is a natural person or an institution.

2. Equity characteristics of the capital instrument – characteristics fall along a continuum from full equity instruments (e.g., perpetual, reflect ownership, governance implications – equivalent to Tier 1 instruments under BASEL as more pure forms of capital) to less permanent or pure hybrid debt/equity instruments (equivalent to Tier 2 instruments under BASEL).

Three general categories (by claim priority) for the types of supplemental capital instruments that could satisfy to various degrees the key public policy principles include:

A. Voluntary Patronage Capital;
B. Mandatory Membership Capital; and
C. Subordinated Debt.

The highest quality capital from the perspectives of consistency with the cooperative model, governance implications, and utility as capital comes in the form of equity instruments purchased by members. The three broad types of supplemental capital instruments fall along this spectrum as follows:

**Spectrum of Supplemental Capital Models**

<table>
<thead>
<tr>
<th>Source</th>
<th>Instrument Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Member/Owner</td>
<td>Membership Capital</td>
</tr>
<tr>
<td></td>
<td>Voluntary Patronage Capital</td>
</tr>
<tr>
<td>External Investor</td>
<td>Subordinated Debt</td>
</tr>
</tbody>
</table>

Each of the three general categories for the types of supplemental capital instruments are discussed below.58

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57 In terms of member disclosure and understanding, a potential complicating factor for credit unions is that savings accounts are called “share accounts,” and certificate of deposit accounts are called “share certificates.” The term “purchased” is used intentionally. Investments made by members in any at risk capital accounts should not be characterized as any form of share account to avoid confusion about the nature of the account and its federally insured status. In addition, there is always the potential for confusion with the common understanding of buying “shares” as referring to stock in a stockholder based institution.

58 Low-income credit unions are currently eligible to issue secondary capital to institutional investors, analogous to the subordinated debt discussed in this paper, and have it count towards the leverage ratio. The models discussed herein would not alter this. For the models discussed, low-income credit unions would be subject to the same restrictions for MMC and VPC as all other credit unions,
A. Voluntary Patronage Capital (VPC)

VPC would be uninsured and subordinate to the NCUSIF, and would be used to cover losses that exceed retained earnings. These instruments are intended to allow members with the financial wherewithal, under strict suitability and disclosure standards, to support the credit union by contributing capital. Purchase of this type of supplemental capital instrument would be optional for natural person members, but not available to institutional members. Voting rights and access to all credit union services otherwise available to members may not be contingent in any way on the purchase of VPC.

This type of supplemental capital would function as equity, not debt, as it is a very long term, non-cumulative capital instrument. Given its utility as capital, VPC would count toward both the net worth ratio and the risk-based net worth ratio, but subject to limits described below given mutuality and risk considerations.

In addition to the conditions enumerated above that apply to all forms of supplemental capital, VPC must be subject to the following:

- To conduct a VPC offering, credit unions must:
  - Be at least adequately capitalized per PCA standards.
  - Have at least 4% of retained earnings to total assets. As a consumer safeguard, and to mitigate the individual and systemic reputation and financial risks, this ensures for this class of capital a sufficient buffer of retained earnings is available at issuance. In addition, a credit union may not issue VPC if it would cause the aggregate level of VPC to exceed 2% of total assets when issued. This provision ensures these accounts are a supplement to the credit union’s capital structure, not a dominant form leading to proportionally less retained earnings, and limits credit unions’ ability to use at-risk member funds to leverage risk-taking or fund inordinate growth strategies.
  - Have received in the most recent calendar year-end, and conduct annually while any VPC accounts are outstanding, an independent CPA opinion audit.
  - Comply with disclosure and transparency standards (e.g., executive compensation) comparable to publicly owned institutions.
  - Receive prior approval of the regulator. The regulator must determine for the written record that the credit union is not in danger of failing, the credit union’s plans for issuing the VPC meet all investor disclosure and suitability requirements, and that the credit union’s planned use of the capital does not involve an unsafe or unsound business strategy.

- VPC needs to be subject to a single obligor limit of 5% of total net worth at time of offering, to prevent concentration of the credit union’s net worth under one person’s control.

- VPC could only be offered to members that have belonged to the credit union for at least one year. In addition, if offered on a single institution basis (see footnote 59), individuals would be limited to a

but would be able to count subordinated debt as net worth when calculating the leverage ratio. All other credit unions would only be able to count subordinated debt toward the risk-based ratio.

Conceptually, instead of offering these types of instruments on a single institution basis, Congress could allow for multiple credit unions to form a vehicle analogous to Trust Preferred Securities (TPS). Only members of the participating credit unions could buy into the TPS, albeit not necessarily in direct financial proportion to their credit union’s relative capital benefit from the vehicle, and have a more diversified risk position across multiple institutions (i.e., not as vulnerable to the failure of a single institution).

Limiting VPC to natural person members is intended to ensure the focus of the credit union and its governance structure remains fully mutual. Institutional investors typically wield disproportionate financial resources compared to natural person members, and could heavily, albeit indirectly given the prohibition of tying voting rights to VPC, influence the affairs of the credit union. This also prevents credit unions that are members of other credit unions from purchasing these types of instruments, which could lead to artificially inflated capital levels and systemic risk.
minimum investment of $10,000 and a maximum of 15% of the daily average total shares held on
deposit over the preceding 12 months. These provisions help ensure some measure of financial
sophistication and wherewithal to absorb the loss of the member, and would ensure any opportunists
and/or high worth members do not undermine the cooperative model.61

- VPC would have a minimum initial maturity of 20 years, with no early redemption option for the
  investor.62 These instruments are transferable to another member eligible to invest in VPC. However,
to accommodate the credit union model (i.e., limited field of membership and no real secondary market
for this form of instrument), VPC would be payable subject to a 5-year waiting period upon a member’s
death or after full membership termination. In other words, all relationships with the credit union,
including loan accounts, need to be closed to trigger the 5-year waiting period.63 In addition, the credit
union can only honor the redemption after the 5-year waiting period on a first come-first served basis if
it would not cause the credit union’s net worth to fall below “well capitalized.”

- Dividends would be non-cumulative and subject to available earnings. Total rates of return for VPC
  instruments would be subject to ceilings set by the regulator and insurer so these accounts function as
capital.64

- VPC must be available to cover losses (as determined by GAAP), including while the institution
  operates as an ongoing concern, that exceed retained earnings and cannot under any circumstances be
  replenished once used to cover losses.

- Clear and robust disclosures and affirmative suitability determination requirements.65 As part of the
disclosure and safeguards for investors, credit unions offering VPC must:
  - Provide a prospectus clearly articulating the risks, including providing peer financial
    performance comparison data and federally insured credit union failure history of over the
    relevant time horizon (20 or more years).
  - Receive affirmative written acknowledgment from the member of receipt of the uninsured and
    risk disclosures, and maintain the signed disclosures for the prescribed retention period.
  - Provide the investor a copy of the most recent independent CPA opinion audit and credit union
    financial statements.

- Credit unions and their employees would be subject to administrative enforcement sanctions for the
  failure to carry out the affirmative disclosure and investor suitability obligations.

61 Congress could consider allowing, at the member’s option, a credit union to pay dividends on share accounts in the form of
purchases of VPC without the member otherwise qualifying to invest in VPC. This approach would allow all members to
incrementally provide patronage capital to the credit union, only putting their credit union earnings at risk and inherently limiting the
rate of exposure to risk of loss (e.g., they can’t in one day put their life savings at risk by using it to buy VPC).
62 While this is not “perpetual,” in light of the limitations of the mutual model there is sufficient permanence to allow this form of
capital to be viewed on a limited basis as a Tier 1 equivalent, and thus be included in the net worth ratio up to the maximum (2% of
assets) allowed.
63 The 5-year provision for VPC intentionally is more stringent than for MMC (no wait) in regard to the death of the member and the
limits of the net worth category. This is due to VPCs individually likely to be far larger in dollar amount than the $50 maximum
MMC, with the corresponding greater potential impact on the credit union’s net worth position for redemptions.
64 An excessive rate could not only lead to profitability concerns, if the rate allowed the investor to recoup the principal at risk in a
short amount of time (especially if through some collusion with insiders), these accounts would not be serving as capital to protect the
insurance fund. Another benefit would be to ensure external investors would be limited in the extent to which credit union earnings
would be directed to them instead of the members, helping preserve the cooperative model.
65 There is the real potential in a credit union failure involving supplemental capital for accusations of a conflict of interest between
the safety and soundness regulator in safeguarding the insurance fund and the disclosures related to the at-risk investor providing
protection for the insurance fund when purchasing supplemental capital instruments. Congress may want to consider the extent to
which these disclosure standards must be vetted beyond the primary regulator, as is the case for the Canadian model.
B. Mandatory Membership Capital (MMC)

Purchase of this type of supplemental capital would be a condition of membership for any person or entity eligible to join the credit union. The idea behind this form of capital is to allow credit unions to convert the par value share currently required to be a member of the credit union in good standing to a form of supplemental capital.\(^{66}\) Specifically, the minimum single par share which a member is required to “purchase” to be a member of the credit union would be uninsured and subordinate to the NCUSIF. Subject to prior regulatory approval,\(^ {67}\) individual credit unions would opt-in to this type of membership structure by adoption of a standard bylaw amendment.

This type of supplemental capital would function as equity, not debt, as it approximates a perpetual, non-cumulative capital instrument. Given its utility as capital, MMCs would count without limit toward both the net worth ratio and the risk-based net worth ratio. It is intended to reflect the cooperative “ownership” and voting rights every member of the credit union has, without changing the one member-one vote principle. It more explicitly reflects each member’s ownership stake in the credit union.\(^ {68}\)

In addition to the conditions enumerated above that apply to all forms of supplemental capital, MMC must be subject to the following:

- Limited to uniform par value not to exceed $50. The uniform par value ensures full mutuality for this ownership interest (one member-one vote). The $50 maximum reduces the barrier to entry for potential members of limited means, and provides protection for the consumer given the negligible level of risk. Proper disclosures would still be required.
- No stated maturity and cannot be withdrawn. However, to accommodate the credit union model (i.e., limited field of membership and no secondary market for this form of instrument), MMCs would be payable upon on a member’s death, without a waiting period, or subject to 5-year waiting period after full membership termination (i.e., all accounts are closed and loans repaid).
- Dividends would be non-cumulative and subject to available earnings.
- Available to cover losses (as determined by generally accepted accounting principles), including while the institution operates as an ongoing concern, that exceed retained earnings and any other forms of supplemental capital that absorb losses ahead of this class of capital (see Section A. on VPC, above), and cannot under any circumstances be replenished once used to cover losses.

C. Subordinated Debt (SD)

Subordinated Debt would be uninsured, subordinate to the NCUSIF, and would be used to cover losses that exceed retained earnings and any MMC or VPC capital. It would have a 5-year minimum initial maturity or notice period with no early redemption option for the investor. Credit unions issuing SD would need to be subject to standard marketplace investor suitability standards and disclosures. SD may not convey any voting

\(^{66}\) A major potential challenge for credit unions selecting this option would be to address the conversion of existing members’ initial par to uninsured status (e.g., disclosures). The presence of this form of capital could also complicate voluntary mergers. In addition, it would create additional challenges for NCUA in conducting emergency mergers and P&As. However, this effect on NCUA’s resolution of problem cases would likely be limited and the NCUSIF is compensated with additional “capital” up front for this. Consistent with current bylaw provisions, members could be given time to reach the par amount in mergers involving an increase.

\(^{67}\) This requirement ensures such a change is done transparently and not while the institution is incurring losses that are likely to harm the members.

\(^{68}\) Any enabling legislation should explicitly affirm the tax-exempt status of state-chartered credit unions in case the IRS were to interpret this as constituting capital stock under section 501(c)(14)(A) of the Internal Revenue Code.
rights, involvement in the management and affairs of the credit union, or conditioned on prescriptive measures directing the credit union’s business strategies.

This type of supplemental capital would function as a hybrid debt-equity instrument. It is the Working Group’s belief that this type of capital instrument should be limited to institutional investors, regardless of whether such investors are members of the credit union or external. Given the debt characteristics and shorter minimum initial maturity, SD would only count toward the risk-based net worth ratio, and only up to 50% of capital instruments (including retained earnings) counting toward the net worth ratio.

In addition to the conditions enumerated above that apply to all forms of supplemental capital, SD must be subject to the following:

- Prior approval of the regulator. The regulator must determine for the written record that the credit union’s plans for issuing the subordinated debt meet all investor disclosure and suitability requirements, and that the credit union’s planned use of the subordinated debt does not involve an unsafe or unsound business strategy.
- A single obligor limit of 10% of total net worth at time of offering, to prevent concentration of the credit union’s net worth under one entity’s control.
- Interest could be cumulative, and would not necessarily be subject to available earnings. SD could be subject to ceilings set by the regulator and insurer to prevent earnings and asset-liability management problems.
- Available to cover losses (as determined by generally accepted accounting principles), including while the institution operates as an ongoing concern, that exceed retained earnings and any subordinate capital (e.g., MMC and VPC) and cannot under any circumstances be replenished once used to cover losses.
- SD would be subject to repudiation by the insurer in conservatorship or liquidation (with return of any remaining principal to the investor), and any subordinated debt instruments that do not comply with all applicable regulatory and statutory requirements will not be included in the risk-based net worth ratio and will subject the issuing credit union to administrative action to cease and desist all such activity.

The models of VPC, MMC and SD attempt to address, with varying degrees of success, the three key principles. The Working Group’s observations and conclusions must be understood in the context of the risk management and safety and soundness issues identified herein. Specifically, the Working Group retains some reservations about the MMC and VPC models given NCUA’s experience with the depletion of supplemental capital accounts at corporate credit unions and low-income designated credit unions. The Working Group is concerned that even heightened disclosure will be insufficient to fully inform investors of the risks and uninsured status of such supplemental capital accounts. While subordinated debt may be a better option, it is of limited value unless it has a longer term (e.g., 20 years) so that it could count towards the leverage ratio (including single obligor and aggregate limits cited herein).

Below is a chart that summarizes the characteristics of each possible supplemental capital model.

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69 If the investor is another federally insured credit union, the investing credit union must deduct from its net worth the amount of the investment in calculating its own risk-based net worth ratio. Also, a credit union accepting subordinated debt investments from other credit unions cannot also be an investor in subordinated debt instruments of other credit unions. This prevents systemic risk and the artificial inflation of credit union capital.

70 This is consistent with BASEL treatment of Tier 2 instruments.

71 An excessive rate could not only lead to profitability concerns, if the rate allowed the investor to recoup the principal at risk in a short amount of time (especially if through some collusion with insiders), these accounts would not be serving as capital to protect the insurance fund. Another benefit would be to ensure external investors would be limited in the extent to which credit union earnings would be directed to them instead of the members, helping preserve the cooperative model.
## Comparative Characteristics of Supplemental Capital Models

<table>
<thead>
<tr>
<th>Instrument Characteristic</th>
<th>VPC</th>
<th>MMC</th>
<th>SD</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Instrument function</strong></td>
<td>Allows members with the financial wherewithal, under strict suitability and disclosure standards, to support the credit union by contributing capital</td>
<td>Allows credit unions to convert the par value share currently required to be a member of the credit union in good standing to a form of supplemental capital</td>
<td>Allows credit unions to raise supplemental capital from external institutional investors while preserving the cooperative model and safeguarding members</td>
</tr>
<tr>
<td><strong>Insured/Uninsured</strong></td>
<td>Uninsured</td>
<td>Uninsured</td>
<td>Uninsured</td>
</tr>
<tr>
<td><strong>Relationship to NCUSIF</strong></td>
<td>Subordinate</td>
<td>Subordinate</td>
<td>Subordinate</td>
</tr>
<tr>
<td><strong>Equity/Debt</strong></td>
<td>Functions as equity, not debt</td>
<td>Functions as equity, not debt</td>
<td>Functions as hybrid debt-equity</td>
</tr>
<tr>
<td><strong>Term &amp; Cumulative</strong></td>
<td>Long term Non-cumulative</td>
<td>Perpetual Non-cumulative</td>
<td>Medium-Long Term Non-cumulative</td>
</tr>
<tr>
<td><strong>Purchaser</strong></td>
<td>Natural person members, but not available to institutional members</td>
<td>Condition of membership for any person or entity eligible to join the credit union</td>
<td>Limited to external institutional investors</td>
</tr>
<tr>
<td><strong>Required/Optional</strong></td>
<td>Optional for natural person members</td>
<td>Required – condition of membership for all new members</td>
<td>Optional for external institutional investors only</td>
</tr>
<tr>
<td><strong>Net Worth Accounting</strong></td>
<td>Count toward both the net worth ratio and the risk-based net worth ratio, but subject to limits described below given mutuality and risk considerations</td>
<td>Count without limit toward both the net worth ratio and the risk-based net worth ratio</td>
<td>Count toward the risk-based net worth ratio, and only up to 50% of capital instruments (including retained earnings) counting toward the net worth ratio</td>
</tr>
<tr>
<td><strong>Loss Coverage</strong></td>
<td>Used to cover losses that exceed retained earnings</td>
<td>Used to cover losses that exceed retained earnings and VPC</td>
<td>Used to cover losses that exceed retained earnings and any MMC or VPC</td>
</tr>
<tr>
<td><strong>Effect on cooperative model</strong></td>
<td>Participation in VPC may not affect any voting rights and involvement in the management and affairs of the credit union in any way different from members who do not participate in VPC.</td>
<td>MMC reflects the cooperative model and preserves the one member-one vote principle. Subject to prior regulatory approval, individual credit unions would opt-in to this membership structure by adoption of a standard bylaw amendment.</td>
<td>SD may not convey any voting rights, involvement in the management and affairs of the credit union, or be conditioned on prescriptive measures directing the credit union’s business strategies.</td>
</tr>
</tbody>
</table>
Section 4 | Statutory and Regulatory Considerations

Congressional action is required to implement additional forms of supplemental capital for natural person credit unions beyond the existing secondary capital for low-income designated credit unions. Further, to ensure that such capital is reflected in the issuing credit union’s “net worth ratio,” which determines its net worth classification under PCA, it will be necessary for Congress to expand the statutory definition of “net worth” accordingly and to make other conforming adjustments to the statutory criteria for PCA.

A. Suggested Statutory Revisions to Implement Supplemental Capital

In reviewing current statutory provisions, the Working Group has identified provisions of the Federal Credit Union Act that would need to be amended if the models for supplemental capital suggested by the Working Group are adopted. The Working Group strongly believes that only the minimum amount of statutory change necessary to accommodate supplemental capital should be made. The Working Group also strongly believes that regulators should have the full authority to promulgate and enforce the disclosure standards sufficient to inform prospective investors of the risks and uninsured status of supplemental accounts as well other safety and soundness issues.

Below are four specific sections of the Federal Credit Union Act which the Working Group believes need to be amended to accommodate supplemental capital as envisioned by the possible models described above.

1. §1757(6) – Share Account Authority for FCUs

The Working Group believes that a new subsection needs to be added to 12 U.S.C. 1756(6) to needed to establish the authority, not otherwise present, for natural person credit unions to offer contributed capital accounts such as VPC and MMC accounts. The following minimum attributes of contributed capital that are needed to ensure that both VPC and MMC truly function as capital should be enumerated by statute. These might include:

- Such accounts may be established only by a credit union that, when offered, has a net worth ratio of at least 4%;
- In the aggregate do not exceed 2% of total assets of the issuing credit union;
- Are subordinate to all other claims against the credit union, including the claims of creditors, shareholders, and the NCUSIF;
- Earn non-cumulative dividends only when there is available earnings;
- Shall be permanently applied to absorb losses of the credit union on a non-replenishable basis per criteria established by the NCUA Board;
- Comply with disclosure and suitability standards established by the NCUA Board;
- Do not convey any voting or ownership rights, and do not affect existing member voting rights; and
- Do not affect access to services otherwise available to persons meeting the minimum requirements for membership, and such access is not contingent on the purchase of such an account;

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73 Id. at §1790d.
These attributes ensure that VPC and MMC truly function as capital, are consistent with the essential characteristics of credit unions, feature adequate consumer safeguards, and are offered only by credit unions that are in healthy financial condition.

2. §1790d(b) – Cooperative Character of Credit Unions

The Working Group believes that this section of the Federal Credit Union Act will need to be amended to allow credit unions to offer capital accounts only to members on a limited basis. Adding language expressly providing that credit unions “may offer capital accounts only to members on a limited basis” would achieve this objective. Further, this language would incorporate contributed capital accounts into the required design of the statutory system of PCA for credit unions, so that these accounts will be reflected in a credit union’s PCA net worth.

Another technical change would be to recognize that credit unions may initially have no net worth. Such a change would be intended to clarify that it is permissible to reflect contributed capital accounts as a supplement to the net worth a credit union already has managed to accumulate.

3. §1790d(o) – Definition of Net Worth

The Working Group recommends that the definition of “net worth” be amended to permit the NCUA Board to reflect contributed capital accounts in a credit union’s net worth. Another useful amendment considered by the Working Group would be to permit an acquiring credit union in a merger to count in its net worth the contributed capital accounts of the target credit union.

In addition, the definition of “net worth” should be expanded to include capital instruments issued by credit unions with the NCUA Board’s approval that are purchased by Government-sponsored entities. To ensure that these instruments truly function as capital, the amendment should mandate that they must be applied to permanently cover losses in excess of retained earnings, must have a 5-year minimum maturity, must be uninsured, and must be subordinate to all other claims.

Finally, the Working Group believes that a definition of “member contributed capital” should be included in this section of the statute in order to be consistent with the suggested amendments to the definition of “net worth.” Any definition should recognize member contributed capital either authorized by the Federal Credit Union Act or by State laws that are determined to be substantially similar to the characteristics of contributed capital accounts enunciated above for §1757(6).

4. §1790d(p) – Income Tax Exemption for Federal Credit Unions

The Working Group believes that a new subsection should be added to this section to make it clear that nothing will affect the federal income tax exemption granted state-chartered credit unions under Section 501(c)(14) of the Internal Revenue Code. Such a change would be intended to clarify that authorization of state-chartered credit unions to offer contributed capital account that qualify as “net worth” will not jeopardize their federal income tax exemption.

74 To put credit unions in parity with other federally-insured financial institutions, Congress should expand the scope of credit union “net worth” to match that of banks’ “leverage limit,” their equivalent of the numerator of the net worth ratio. Whereas credit union “net worth” is presently limited by law to “retained earnings . . . as determined under [GAAP],” 12 U.S.C. 1790d(o)(2)(A), banks’ “leverage limit” is much broader, comprising “tangible equity,” 12 U.S.C. 1831o(c)(3)(A)(i) and (c)(3)(B). As permitted by law, the Federal banking agencies have defined “tangible equity” by regulation as essentially the equivalent of “equity” under GAAP, less intangible assets other than mortgage servicing assets. 12 C.F.R. 325.2(u). See also id. §325.2(v) (definition of “Tier 1 capital or core capital”).
B. Other Statutory Revisions to Enhance PCA

The need for statutory revisions to accommodate supplemental capital provides the opportunity to make a number of statutory enhancements to improve and simplify the implementation of PCA generally, in light of the last eight years of implementation experience. These enhancements were proposed in the NCUA Board’s April 2007 Prompt Corrective Action Reform Proposal (see footnote 14).

Insured credit unions defined as “new” are subject to a more relaxed alternate system of PCA than are non-“new” credit unions. Presently, a credit union is defined as “new” as long as it has been in operation for less than 10 years and has not more than $10 million in total assets. The 2007 PCA Reform Proposal advocates increasing the time window for remaining “new” credit unions from 10 to 20 years, and making the $10 million asset ceiling adjustable for inflation by the NCUA Board.

The PCA net worth levels set by law for the five net worth categories presently may be adjusted by the NCUA Board when, and to the extent that, the Federal banking agencies adjust the minimum “leverage limit” that applies to banks, provided the reason for the adjustment justifies a corresponding adjustment to the minimum PCA net worth levels. The 2007 PCA Reform Proposal would revise the criteria for adjusting the minimum PCA net worth levels by making them contingent on the adjustments made by the FDIC alone, instead of by “the Federal banking agencies,” to any of the minimum “relevant capital measures” that apply to banks, instead of to the “leverage limit” only.

The PCA “risk-based net worth requirement” (RBNW) presently applies to credit unions that the NCUA Board designates as “complex” according to a credit union’s portfolio of assets and liabilities, which are not defined. The 2007 PCA Reform Proposal would eliminate the “complex” designation and allow the NCUA Board to define which credit union assets and liabilities should be the basis for determining whether the RBNW applies. Further, the design of the RBNW is required to address “any material risks against which the net worth ratio required . . . to be adequately capitalized may not provide adequate protection,” but the law does not define the material risks this standard is based on. The 2007 PCA Reform Proposal would allow the NCUA Board to define the “material risks” that apply to credit unions, and for which the FDIC applies a comparable PCA standard to banks.

The statutory “earnings retention requirement” compels less than “well capitalized” credit unions to annually set aside a minimum of 4/10ths of one percent (0.4%) of their total assets to build net worth. The 2007 PCA Reform Proposal would eliminate the “earnings retention requirement” entirely and would instead require “adequately capitalized” credit unions, which presently are not required to submit a net worth restoration plan (NWRP), to submit an NWRP if “material safety and soundness concerns caused the credit union to become less than well capitalized” and “the safety and soundness concerns remain unresolved.”

Credit unions that are less than “adequately capitalized” are already compelled to submit an NWRP for NCUA Board approval. The 2007 PCA Reform Proposal would allow the NCUA Board to exempt an “adequately capitalized” or “undercapitalized” credit union from this mandate if it “becomes or remains no less than undercapitalized due to the impact of a major natural or man-made disaster.”

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75 12 U.S.C. 1790d(b)(2); 12 C.F.R. 702.301 et seq.
77 Id. at §1790d(c)(2).
78 Id. at §1790d(d)(1).
79 Id. at §1790d(d)(2).
80 Id. at §1790d(e).
81 Id. at §1790d(f)(1).
The NCUA Board may not delegate its statutory authority to reclassify to the next lowest net worth category (other than “critically undercapitalized”) a credit union that either is in an unsafe or unsound condition or has failed to correct an unsafe or unsound practice.\(^\text{82}\) The 2007 PCA Reform Proposal would allow the NCUA Board to delegate this authority to staff when the unsafe or unsound practice or condition is due to interest rate risk, provided that the staff’s delegated reclassification decision is reviewable by the NCUA Board.

The NCUA Board is generally required, within 90 days of the date a credit union is classified as “critically undercapitalized,” to either conserve or liquidate the credit union, or to “take such other action as the Board determines would better achieve the purpose of [PCA].”\(^\text{83}\) But it is unclear whether the Board itself, or the credit union at the Board’s direction, is intended to actually implement “such other action” in lieu of conservatorship and liquidation. The 2007 PCA Reform Proposal would clarify that the NCUA Board may “order the credit union to take such other action,” while confirming that the Board retains discretion to decide what that action should be.

Even when a “critically undercapitalized” credit union is directed by the NCUA Board to take “such other action” in lieu of conservatorship and liquidation, the NCUA Board still has no choice but to liquidate that credit union if it remains classified as such “on average during the calendar quarter beginning 18 months after the date on which the credit union became critically undercapitalized.”\(^\text{84}\) If the 18 month window preceding the “calendar quarter” averaging period ends one or two months before a quarter-end, it will extend the 18-month window by one or two months, respectively. To ensure a uniform time frame for mandatory liquidation, the 2007 PCA Reform Proposal would omit the “calendar quarter” modifier for the 18-month period and set the net worth averaging period as “90 calendar days beginning 18 months after” the credit union was first classified “critically undercapitalized.”

Finally, before the NCUA Board acts to conserve or liquidate a federally insured state-chartered credit union on PCA grounds, it must first offer the appropriate State official the opportunity to conserve or liquidate the federally insured state-chartered credit union on his or her own, without NCUA involvement.\(^\text{85}\) When a State official accepts this opportunity, it is unclear what subsequent action he or she must take to achieve the purpose of PCA once the federally insured state-chartered credit union is conserved (e.g., merger) or liquidated, or if the official must take any action at all. To ensure that the State official acts to achieve the purpose of PCA in the case of a conserved or liquidated federally insured state-chartered credit union, the 2007 PCA Reform Proposal would allow a State official the opportunity to conserve or liquidate a federally insured state-chartered credit union only if “the Board determines that such action by the official will carry out the purpose of [PCA].”

\(^{\text{82}}\) Id. at §1790d(h).
\(^{\text{83}}\) Id. at §1790d(i)(1)(B).
\(^{\text{84}}\) Id. at §1790d(i)(3)(A) (emphasis added).
\(^{\text{85}}\) Id. at §1790d(l)(3)(A)(ii).
Section 5 | Modeling Impact

NCUA conducted an analysis based on different scenarios to assess how supplemental capital could impact credit unions. The analysis helps quantify the potential financial benefit to credit unions and may be helpful in assessing whether the benefits outweigh expending political capital in the pursuit of a legislative change in this area. For this white paper, the impact of supplemental capital was evaluated using three scenarios.

A. **Maximum Benefit:** The maximum amount of supplemental capital that could be raised applying reasonable limitations.

B. **Potential Benefit:** The amount of supplemental capital that could be raised taking into account the limited resources of smaller credit unions and exclusion of all credit unions with current capital levels well in excess of regulatory requirements.

C. **Expected Benefit:** An estimate of the amount of supplemental capital that could be raised by the credit unions likely to engage in the activity.

The following statutory and regulatory controls were applied in preparing the scenarios:

- MMC would be limited to $50 per member;
- VPC would be limited to 2% of member shares and retained earnings; and
- SD would be limited to 50% of retained earnings.

To determine the different impact on credit unions in varying asset ranges, the model, using data as of December 31, 2009 was used to compute the impact for the 2,995 credit unions with assets less than $10 million and the 4,560 credit unions with assets greater than $10 million.
A. Maximum Benefit

The maximum level of supplemental capital that could be acquired using the controls listed is $65 billion, assuming all credit unions use all types of supplemental capital.

<table>
<thead>
<tr>
<th>Maximum Benefit - Mandatory Membership Capital</th>
<th>Number of Members</th>
<th>Maximum Amount Raised</th>
<th>Aggregate/Average Increase in Capital Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>All FICUs</td>
<td>89,932,558</td>
<td>$4.5 Billion</td>
<td>51 bps/120 bps</td>
</tr>
<tr>
<td>FICUs - Assets &lt; $10 Million</td>
<td>2,848,602</td>
<td>$142 Million</td>
<td>123 bps/192 bps</td>
</tr>
<tr>
<td>FICUs – Assets &gt; $10 Million</td>
<td>87,083,956</td>
<td>$4.35 Billion</td>
<td>50 bps/72 bps</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Maximum Benefit - Voluntary Patronage Capital</th>
<th>Member Shares and Retained Earnings</th>
<th>Maximum Amount Raised</th>
<th>Aggregate/Average Increase in Capital Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>All FICUs</td>
<td>$838.1 Billion</td>
<td>$16.7 Billion</td>
<td>168 bps/165 bps</td>
</tr>
<tr>
<td>FICUs - Assets &lt; $10 Million</td>
<td>$11.4 Billion</td>
<td>$228 Million</td>
<td>164 bps/160 bps</td>
</tr>
<tr>
<td>FICUs – Assets &gt; $10 Million</td>
<td>$826.7 Billion</td>
<td>$16.5 Billion</td>
<td>168 bps/169 bps</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Maximum Benefit - Subordinated Debt</th>
<th>Net Worth</th>
<th>Maximum Amount Raised</th>
<th>Aggregate/Average Increase in Capital Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>All FICUs</td>
<td>$87.7 Billion</td>
<td>$43.86 Billion</td>
<td>426 bps/524 bps</td>
</tr>
<tr>
<td>FICUs - Assets &lt; $10 Million</td>
<td>$1.76 Billion</td>
<td>$881 Million</td>
<td>601 bps/597 bps</td>
</tr>
<tr>
<td>FICUs – Assets &gt; $10 Million</td>
<td>$86.0 Billion</td>
<td>$42.98 Billion</td>
<td>423 bps/476 bps</td>
</tr>
</tbody>
</table>

The data shows that small credit unions, which would be more likely to only issue MMC, obtain the largest improvement in the capital ratio measure due to the higher number of members in relation to total assets. SD accounts for over 67% of the maximum supplemental capital and would be subject to the highest levels of supervisory review due to the size potential, complexity, and cost.

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For this section, the capital ratio is the current net worth plus the addressed supplemental capital divided by total assets.
B. Potential Benefit

Under this analysis, the total potential benefit is $50.9 billion in acquired supplemental capital. Credit unions with lower capital levels would be restricted or find it difficult to issue supplemental capital. Credit unions with high levels of net worth would not need supplemental capital. For this analysis, credit unions with less than 4% and more than 12% net worth were excluded. With these exclusions the sample size for all credit unions is reduced to 3,769 with 915 with assets less than $10 million and 2,854 with assets over $10 million.

<table>
<thead>
<tr>
<th>Potential Benefit - Mandatory Membership Capital</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Number of Members</strong></td>
<td><strong>Maximum Amount Raised</strong></td>
</tr>
<tr>
<td>All FICUs</td>
<td>73,115,452</td>
</tr>
<tr>
<td>FICUs - Assets &lt; $10 Million</td>
<td>1,040,745</td>
</tr>
<tr>
<td>FICUs – Assets &gt; $10 Million</td>
<td>72,074,707</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Potential Benefit - Voluntary Patronage Capital</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Member Shares and Retained Earnings</strong></td>
<td><strong>Maximum Amount Raised</strong></td>
</tr>
<tr>
<td>All FICUs</td>
<td>$699.6 Billion</td>
</tr>
<tr>
<td>FICUs - Assets &lt; $10 Million</td>
<td>$4.0 Billion</td>
</tr>
<tr>
<td>FICUs – Assets &gt; $10 Million</td>
<td>$695.6 Billion</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Potential Benefit - Subordinated Debt</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net Worth</strong></td>
<td><strong>Maximum Amount Raised</strong></td>
</tr>
<tr>
<td>All FICUs</td>
<td>$66.6 Billion</td>
</tr>
<tr>
<td>FICUs - Assets &lt; $10 Million</td>
<td>$375 Million</td>
</tr>
<tr>
<td>FICUs – Assets &gt; $10 Million</td>
<td>$66.2 Billion</td>
</tr>
</tbody>
</table>

C. Expected Benefit

The most reasonable estimate projects $11.58 billion in total acquired supplemental capital, which would increase current net worth in credit unions by 11.6%. Many credit unions that are good candidates for supplemental capital will not choose to use the alternative sources. Under this analysis, the estimated number of credit unions that would use supplemental capital is approximately 1,885 or 25% of credit unions. Estimating the extent to which supplemental capital will be used is highly subjective. The following tables contain an estimate of supplemental capital that would actually be issued based on the assumptions used in the analysis.

The ease of use, low entry cost, and close affiliation to standard cooperative practices of the MMC results in the potential for high levels of participation. A utilization rate of 50 percent of “potential benefit” credit unions was used to estimate how much MMC could be generated within a few years. This equates to 1,885 credit unions.
Due to the cost and complexity associated with issuing VPC and SD, the estimated benefit only includes credit unions with total asset over $100 million which reduces the number of potential issuers to 1,098 credit unions. The estimated utilization of VPC was 30 percent out of the 1,098 credit unions, which equates to 329 credit unions.

### Expected Benefit - Mandatory Membership Capital

<table>
<thead>
<tr>
<th></th>
<th>Number of Members</th>
<th>Maximum Amount Raised</th>
<th>Aggregate/Average Increase in Capital Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>All FICUs</td>
<td>36,557,726</td>
<td>$1.83 Billion</td>
<td>49 bps/96 bps</td>
</tr>
<tr>
<td>FICUs - Assets &lt; $10 Million</td>
<td>520,373</td>
<td>$26.0 Million</td>
<td>127 bps/175 bps</td>
</tr>
<tr>
<td>FICUs – Assets &gt; $10 Million</td>
<td>36,037,354</td>
<td>$1.80 Billion</td>
<td>49 bps/71 bps</td>
</tr>
</tbody>
</table>

### Expected Benefit - Voluntary Patronage Capital

<table>
<thead>
<tr>
<th></th>
<th>Member Shares and Retained Earnings</th>
<th>Maximum Amount Raised</th>
<th>Aggregate/Average Increase in Capital Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>FICUs - Assets &lt; $100 Million</td>
<td>$0</td>
<td>$0</td>
<td>n/a</td>
</tr>
<tr>
<td>FICUs – Assets &gt; $100 Million</td>
<td>$188.5 Billion</td>
<td>$3.77 Billion</td>
<td>168 bps/171 bps</td>
</tr>
</tbody>
</table>

Due to the higher cost, the number of credit unions using SD is projected to be less than credit unions using VPC. The estimated utilization of SD was 20 percent out of the 1,098 credit unions for an estimated 220 credit unions.

### Expected Benefit - Subordinated Debt

<table>
<thead>
<tr>
<th></th>
<th>Net Worth</th>
<th>Maximum Amount Raised</th>
<th>Aggregate/Average Increase in Capital Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>FICUs - Assets &lt; $100 Million</td>
<td>$0 Million</td>
<td>$0 Million</td>
<td>n/a</td>
</tr>
<tr>
<td>FICUs – Assets &gt; $100 Million</td>
<td>$11.97 Billion</td>
<td>$5.98 Billion</td>
<td>391 bps/393 bps</td>
</tr>
</tbody>
</table>

The use of joint offerings through trust preferred securities would enable smaller credit unions to issue non-MMC supplemental capital which would increase the number of potential users while not greatly increasing the total amount of supplemental capital. This potential was not modeled as part of the analysis conducted.

The various scenarios indicate a substantial number of credit unions are in a position to improve their capital base with supplemental capital. At the same time, the industry-wide measure of supplemental capital utilization is not projected to result in an overreliance upon supplemental capital.
Section 6 | Observations and Conclusions

This white paper is the culmination of an initiative to explore NCUA’s current authority to permit federally insured credit unions to offer supplemental capital that counts towards statutory “net worth” requirements, to identify key public policy considerations for any extension of NCUA’s authority to permit the issuance of supplemental capital by federally insured credit unions and to set forth the Working Group’s observations and conclusions on the risk management, regulatory safety and soundness and consumer protection frameworks that should be considered to appropriately implement supplemental capital. In developing its observations and conclusions, the Working Group sought to balance NCUA’s experience with supplemental capital and risk management issues, including systemic and reputation risk, with the recognition that supplemental capital authority can be implemented in a manner consistent with the cooperative, mutual credit union model.

While credit union capital levels are good—9.91% net worth ratio as of December 31, 2009—U.S. credit unions remain the only financial institutions that do not have access to sources of capital beyond retained earnings. All credit unions rely almost exclusively on retained earnings to build capital. Two types of credit unions, low-income designated credit unions and corporate credit unions, are permitted forms of supplemental capital. NCUA’s current authority to allow all other federally insured credit unions the ability to offer supplemental capital is limited and would not meet the PCA definition of “net worth.” The Working Group concluded that affording credit unions the ability to raise supplemental capital that counts towards PCA “net worth” requirements is an appropriate policy consideration.

The Working Group also concluded that the NCUA’s two PCA reform proposals that have been advanced would resolve several of the concerns of the credit union system relative to capital requirements and the adverse impact from PCA. Because the proposals incorporate a more robust risk-based capital standard, additional emphasis is placed on credit unions understanding and measuring the risk of activities, services or operations in relation to their capital level.

Based on its research and dialogue with state and international regulators, the Working Group concluded that any form of supplemental capital for credit unions should adhere to three key public policy principles: (1) preservation of the cooperative mutual credit union model; (2) robust investor safeguards; and (3) prudential safety and soundness requirements. The Working Group developed three potential models for supplemental capital that adhere to the identified public policy considerations: Voluntary Patronage Capital (VPC), Mandatory Membership Capital (MMC), and Subordinated Debt (SD).

The Working Group identified areas in the Federal Credit Union Act that would need revisions to accommodate supplemental capital as well as to make further statutory enhancements to improve and simplify the implementation of PCA generally, in light of the last eight years of implementation experience. The Working Group recognizes that the safety and soundness as well as investor safeguards would need to be enunciated in much greater depth through any implementing regulations. In addition, the Working Group modeled the maximum, potential and expected benefit of the three potential supplemental capital models.

The Working Group’s conclusions must be understood in the context of the risk management and safety and soundness issues identified herein. NCUA’s experience with the depletion of supplemental capital accounts at corporate credit unions and low-income designated credit unions does raise reservations with the Working Group. Specifically, the Working Group is concerned that even heightened disclosure will be insufficient to fully inform investors of the risk and uninsured status of supplemental capital accounts. The Working Group also acknowledges that both the corporate network and the loss history of low-income designated credit unions present similar challenges to the general natural person credit union population. Regulators will have to promulgate and enforce disclosure standards sufficient to inform prospective investors of the risks and uninsured status of such supplemental capital accounts.

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In summary and based on its review and analysis, the Working Group offers the following observations and conclusions:

1. Affording credit unions the ability to raise supplemental capital that counts towards PCA “net worth” requirements is an appropriate policy consideration;

2. PCA regulatory reform including a more robust risk-based capital system, as advanced by the NCUA Board in 2005 and 2007, should continue to be pursued as a priority. The reforms combined with supplemental capital could afford credit unions the opportunity to more effectively manage capital levels;

3. Any statutory change that affords credit unions the ability to count supplemental capital towards PCA “net worth” must be accompanied by robust regulatory authority to assure reasonable safeguards and risk parameters are put in place.
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