BRIEF HISTORY OF ALTERNATIVE CAPITAL
§1790d(o)(3) Net worth ratio.—The term “net worth ratio” means, with respect to a credit union, the ratio of the net worth of the credit union to the total assets of the credit union.
§1790d(o)(2) Net worth.—The term “net worth”—

(A) with respect to any insured credit union, means the retained earnings balance of the credit union, as determined under generally accepted accounting principles, together with any amounts that were previously retained earnings of any other credit union with which the credit union has combined;

(B) with respect to any insured credit union, includes, at the Board’s discretion and subject to rules and regulations established by the Board, assistance provided under section 208 to facilitate a least-cost resolution consistent with the best interests of the credit union system; and

(C) with respect to a low-income credit union, includes secondary capital accounts that are—

(i) uninsured; and

(ii) subordinate to all other claims against the credit union, including the claims of creditors, shareholders, and the Fund.
§1790d(d) Risk-based net worth requirement for complex credit unions.—

(1) In general.—The regulations required under subsection (b)(1) of this section shall include a risk-based net worth requirement for insured credit unions that are complex, as defined by the Board based on the portfolios of assets and liabilities of credit unions.

(2) Standard.—The Board shall design the risk-based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection.
# Secondary vs. Supplemental Capital

<table>
<thead>
<tr>
<th></th>
<th>Available to</th>
<th>Included in Net Worth Ratio</th>
<th>Included in Risk-based Capital Ratio</th>
<th>Instrument Type*</th>
<th>Investors*</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Secondary Capital</strong></td>
<td>LICU only (1790d(o)(2)(C))</td>
<td>Yes (1790d(o)(2))</td>
<td>Yes</td>
<td>Debt/Borrowing (1757(9)) • Uninsured (1790d(o)(2)(C)(i)) • Subordinate to all other claims (1790d(o)(2)(C)(ii))</td>
<td>Nonnatural person members and nonnatural person nonmembers</td>
</tr>
<tr>
<td><strong>Supplemental Capital</strong></td>
<td>All FICUs*</td>
<td>No</td>
<td>Yes</td>
<td>Debt/Borrowing (1757(9)) • Uninsured • Subordinate to NCUSIF</td>
<td>TBD</td>
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</tbody>
</table>

* FISCUs would be based on state law
§1757(9) - to borrow, in accordance with such rules and regulations as may be prescribed by the Board, from any source, in an aggregate amount not exceeding, except as authorized by the Board in carrying out the provisions of subchapter III of this chapter, 50 per centum of its paid-in and unimpaired capital and surplus: Provided, That any Federal credit union may discount with or sell to any Federal intermediate credit bank any eligible obligations up to the amount of its paid-in and unimpaired capital
§701.38 Borrowed funds from natural persons

(a) Federal credit unions may borrow from a natural person, provided:

(1) The borrowing is evidenced by a signed promissory note which sets forth the terms and conditions regarding maturity, prepayment, interest rate, method of computation, and method of payment;

(2) The promissory note and any advertisement for such funds contains conspicuous language indicating that:

   (i) The note represents money borrowed by the credit union;
   
   (ii) The note does not represent shares and, therefore, is not insured by the National Credit Union Share Insurance Fund.
### Secondary vs. Supplemental Capital

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§1790(o)(2) Net worth.—The term “net worth”—

(C) with respect to a low-income credit union, includes secondary capital accounts that are—

(i) uninsured; and

(ii) subordinate to all other claims against the credit union, including the claims of creditors, shareholders, and the Fund
# Secondary vs. Supplemental Capital

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<th>Investors*</th>
</tr>
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</table>
| Secondary Capital              | LICU only (1790d(o)(2)(C)) | Yes (1790d(o)(2)) | Yes | Debt/Borrowing (1757(9))
  • Uninsured (1790d(o)(2)(C)(i))
  • Subordinate to all other claims (1790d(o)(2)(C)(ii)) | Nonnatural person members and nonnatural person nonmembers |
| Supplemental Capital           | All FICUs*    | No                           | Yes | Debt/Borrowing (1757(9))
  • Uninsured
  • Subordinate to NCUSIF | TBD |

* FISCUs would be based on state law
Regulatory Limit on Secondary Capital Investors

701.34(b) *Acceptance of secondary capital accounts by low-income designated credit unions.* A federal credit union having a designation of low-income status pursuant to paragraph (a) of this section may accept secondary capital accounts from nonnatural person members and nonnatural person nonmembers subject to the following conditions:
## Secondary vs. Supplemental Capital

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<tr>
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<td>Yes</td>
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<td>Supplemental Capital</td>
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<td>Yes</td>
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* FISCUs would be based on state law
TOP SUPPLEMENTAL CAPITAL CONSIDERATIONS
Top Supplemental Capital Considerations

1. Securities laws
2. Insurer’s Conditions to Count as Capital for PCA Purposes
3. Tax exemption
4. Utility of supplemental capital
Securities Laws

• Supplemental and secondary capital, counted as regulatory capital, offered by CUs would likely be deemed “securities” for purposes of federal and state laws. Section 2(1) of Securities Act, 15 U.S.C. § 77b(a)(1)

• What this means
  – Securities subject to SEC regulations despite exemptions
  – Disclosure requirements (12 C.F.R. Part 16, the OCC’s Securities Offering Disclosure Rules)
  – Anti-fraud requirements always apply

• Need to ensure NCUSIF is protected (must be able to withstand challenge)
Transactions exempted from the registration requirements of section 5 of the Securities Act of 1933 are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws.

- Intent is to prevent fraud, deceit and incorrect or misleading statements or omissions in the offering, purchase and sale of securities.

Clear and complete disclosure is a critical factor in ensuring compliance with anti-fraud provisions.
Capital Characteristics to Protect NCUSIF

• **Permanence**
  – At least five years
  – Call option controlled by issuer with supervisory approval

• **Capacity to absorb losses as a going concern**
  – Instruments must be subordinated to the interest of the insurance fund, cannot be guaranteed or secured

• **Flexibility of payments**
  – Interest payment must be capable of being cancelled on a permanent noncumulative basis without constituting a default
  – Interest provisions must not contain any feature which would provide an incentive to exercise any call option
Secondary Capital Regulations (§701.34)

Related to the Account
• Non-natural persons only
• Non-share account
• May not be pledged as collateral by investor
• Executed using a contract reflecting terms and conditions contained in regulation
• Executed with “Disclosure and Acknowledgment” set forth in regulation

Related to Regulatory Capital
• Approved capital plan
• Uninsured
• Minimum maturity 5 years
• Reduction then maturity < 5 years
• Subordinate to all other claims
• NCUA ability to limit payments
OCC Requirement for Sub-debt as Capital

1. Original maturity at least 5 years
2. Not a deposit and not insured by FDIC
3. Subordinated to claims of depositors
4. Unsecured
5. Ineligible as collateral for a loan by the issuing bank
6. Once scheduled payments of principal begin, all scheduled payments will be made annually not less than prior year
7. Requirements for issuance and repayment
8. Callable only at the initiative of the issuer with OCC approval
9. Must comply with Securities Offering Disclosure Rules in 12 CFR 16
Bank Regulatory Capital Components

- **Tier 2 (ALLL, preferred stock, sub-debt)**
- **Additional Tier 1 (noncumulative perpetual preferred stock)**
- **Common Equity Tier 1 (Common Stock and Retained Earnings)**

Subject to limits, deductions and adjustments

- ALLL limited to 1.25% of gross risk-weighted assets
- Minimum Total Capital of 10% to be well capitalized (RBC %)
- Minimum Total Tier 1 of 8% to be well capitalized (RBC %)
- Minimum Total Tier 1 of 5% of assets to be well capitalized (Leverage Ratio)
- Minimum CET1 of 6.5% to be well capitalized (RBC %)
Credit Union Regulatory Capital

Credit Union Regulatory Capital Components

- ALLL: No limit on ALLL (RBC %)
- Secondary Capital: No limit on Secondary Capital – generally not prudent to be primary capital source
- Retained Earnings: No minimum requirement for retained earnings
- Total capital of 10% to be well capitalized (RBC %)
- Total net worth of 7% of assets to be well capitalized (leverage ratio)

Subject to limits and deductions
§1768. Taxation.—The Federal credit unions organized hereunder, their property, their franchises, capital, reserves, surpluses, and other funds, and their income shall be exempt from all taxation now or hereafter imposed by the United States or by any State, Territorial, or local taxing authority; except that any real property and any tangible personal property of such Federal credit unions shall be subject to Federal, State, Territorial, and local taxation to the same extent as other similar property is taxed. Nothing herein contained shall prevent holdings in any Federal credit union organized hereunder from being included in the valuation of the personal property of the owners or holders thereof in assessing taxes imposed by authority of the State or political subdivision thereof in which the Federal credit union is located; but the duty or burden of collecting or enforcing the payment of such a tax shall not be imposed upon any such Federal credit union and the tax shall not exceed the rate of taxes imposed upon holdings in domestic credit unions.
SCU Tax Exemption

State Chartered Credit Unions - Section 501(c)(14)(A) of the Internal Revenue Code provides an exemption from federal income tax for “credit unions without capital stock organized and operated for mutual purposes without profit”

• No definition for “capital stock.” Potential need for IRS ruling for issuances.
Tax Exemption

• Credit unions lack access to capital markets (Treasury Study of 2001) – reason for higher net worth ratio

• Reason for credit union tax exemption (Treasury 2001):
  – Taxing credit unions on their shares, much as banks are taxed on their capital shares, “places a disproportionate and excessive burden on credit unions” because they function as deposits
  – Credit unions are mutual or cooperative organizations operated entirely by and for their members

• In 1951 Congress removed the thrift tax exemption due to the fact that the borrowers and depositors were not necessarily the same individuals thus loss of “mutuality”
LICUs

Secondary Capital Issuers

LICUs with Secondary Capital, 72

LICUs without Secondary Capital, 2225

Call report data as of 12/31/15
Distribution of FICUs Issuing Secondary Capital

2015

Total of $22 million as of 12/31/2015

Total of $154.7 million as of 12/31/2015

Call Report data
## Low-Income Designated Credit Unions (LICUs)

<table>
<thead>
<tr>
<th>Description</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of FICUs with low income designation (LICUs)</td>
<td>2,297</td>
</tr>
<tr>
<td>Total assets held by FICUs with low income designation</td>
<td>$324.7 billion</td>
</tr>
<tr>
<td>Number of LICUs reporting subordinated debt</td>
<td>72</td>
</tr>
<tr>
<td>Total subordinated debt included in net worth</td>
<td>$176,823,581</td>
</tr>
<tr>
<td>Total subordinated debt not included in net worth</td>
<td>$12,353,893</td>
</tr>
<tr>
<td>Percentage of total subordinated debt in net worth held by the two LICUs</td>
<td>58.3%</td>
</tr>
<tr>
<td>Average amount of subordinated debt</td>
<td>$2,455,883</td>
</tr>
<tr>
<td>Average amount of subordinated debt for LICUs excluding the two LICUs</td>
<td>$1,054,623</td>
</tr>
<tr>
<td>Average Net Worth Ratio of 72 LICUs with subordinated debt</td>
<td>9.79%</td>
</tr>
<tr>
<td>Average Net Worth Ratio of 72 LICUs excluding subordinated debt</td>
<td>6.82%</td>
</tr>
<tr>
<td>Average Risk-based Capital Ratio of 72 LICUs with subordinated debt</td>
<td>18.40%</td>
</tr>
<tr>
<td>Average Risk-based Capital Ratio of 72 LICUs excluding subordinated debt</td>
<td>14.26%</td>
</tr>
</tbody>
</table>

Call report data as of 12/31/15
Distribution of Risk-Based Capital Ratio

As of 12/31/2015 – FICUs > $100 Million

NCUA Board Briefing - Supplemental Capital
## Analysis on Potential Use of Supplemental Capital

<table>
<thead>
<tr>
<th>Description</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td># of FICU with NWR &gt; 8% and RBC ratio &lt; 13.5%</td>
<td>391</td>
</tr>
<tr>
<td># of FICU with NWR &gt; 8% and RBC ratio &lt; 13.5% and assets over $100 million</td>
<td>224</td>
</tr>
<tr>
<td># of the 224 that are already LICUs</td>
<td>84</td>
</tr>
<tr>
<td># of the 84 LICUs that have outstanding secondary capital</td>
<td>3 (Total of $9.85 million in net worth)</td>
</tr>
<tr>
<td># of FICU with NWR &gt; 8% and RBC ratio &lt; 13.5% and assets over $100 million and not LICUs</td>
<td>140</td>
</tr>
<tr>
<td>Net worth of the 140 FICUs</td>
<td>$9.2 billion</td>
</tr>
<tr>
<td>Maximum amount of subordinated debt that could be issued at 50% of net worth</td>
<td>$4.5 billion</td>
</tr>
<tr>
<td>Amount of subordinated debt needed by the 140 FICUs to achieve 13.5% RBC ratio</td>
<td>$1 billion</td>
</tr>
</tbody>
</table>

Call report data as of 12/31/15
## Bank Use of Subordinated Debt

With Outstanding Subordinated Debt

<table>
<thead>
<tr>
<th>($ in millions)</th>
<th>12/31/15</th>
<th>12/31/14</th>
<th>12/31/13</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Banks ($)</td>
<td>$91,597</td>
<td>$98,083</td>
<td>$99,618</td>
</tr>
<tr>
<td>All Banks (% assets)</td>
<td>0.57%</td>
<td>0.63%</td>
<td>0.68%</td>
</tr>
<tr>
<td>Community Banks ($)</td>
<td>$479</td>
<td>$497</td>
<td>$447</td>
</tr>
<tr>
<td>Community Banks (% assets)</td>
<td>0.02%</td>
<td>0.02%</td>
<td>0.02%</td>
</tr>
</tbody>
</table>

FDIC Quarterly
Cost of Bank Issued Sub-Debt

- 2015 issuances (17 in sample) had coupons ranging from 4.25% to 6.75% (1 $2 million issuance at 1.75%)
- Sample of 2016 issuances – 5.25% to 6.25% fixed for 5 years, 3 month LIBOR + 394 to 496 bp to 2026
- Commission on private issuances – range from 125 bp to 300 bp for smaller issuances (less than $30 million)

Source: Capital Markets Announcements, Form D Notice of Exempt Offing, SNLFinancial
Purchasers of Sub-Debt

• Pension Funds
• Insurers
• Mutual Funds
• Other Community Banks
• Primarily private offerings
Purpose of Sub-Debt

• Mergers and acquisitions
• Redemption of TARP (due to interest rate increases)
• Fund growth
• Issuers generally have pre-issuance Tier 1 leverage ratios of 9% to 10.5% and total capital ratios of 11% to 12%
Potential Regulation Additions

• Borrowing rule
• Anti-fraud requirements
• Dealer/broker requirements
• Required disclosures
• Minimum suitability standards
• Permissibility issues (round robin investing)
• Insider purchase limits and disclosures
  – Requirement issuing FCUs enact, maintain, and enforce insider trading policies
Potential Regulation Relaxation

- Remove public unit and non-member account limits in §701.32
- Allow non-institutional investors to purchase secondary capital
- Relax pre-approval requirement for issuance of secondary capital (levels for notice, notice and approval, and no issuance)
- Remove borrowing limit on FISCU (§741.2) – survey of regions revealed no such requests
- Allow all secondary capital to be called with NCUA approval – not just discounted portion
- Simplify capital redemption standards making it clear NCUA will approve if no longer needed
Potential Cohering Changes

- Revise bylaws
- Remove accounting treatment – GAAP
- Revise payout priorities in 709
  - Allow for structured securities for supplemental capital
- Allocate capital treatment items to Part 702
 Regulation Restructure Summary

- 701.32 – Payment on shares by public units and nonmembers
- 701.34 – Designation as low income status
- 701.38 – Borrowed funds from natural persons
- 701.40 – Subordinated debt (new rule)
- 702 – Capital adequacy
- 703.14 & 741.219 - Permissible investments
- 709.5 – Payout priorities
- 741.2 – Maximum borrowing authority
- 741.4(b) – Insurance premium and 1 percent
- 741.9 – Uninsured membership shares
- 742.204 - Maximum public unit and nonmember accounts, and low-income designation
- 745 – Cohering changes
Next Steps

• Continue research

• Develop a Advance Notice of Proposed Rulemaking (ANPR) for NCUA Board consideration

  – Questions in the ANPR can be used help focus the responses on specific issues