

NASCUS

Alternative Capital for Credit Unions ...

Why Not?

Summer 2005

Alternative Capital for Credit Unions—Why Not?

Alternative capital for credit unions has been a hotly debated topic in recent years. Arguments have been presented pro and con about the concept, each side presenting their argument with conviction and true passion.

We all share the long-term vision of a safe and sound state credit union system. NASCUS appreciates your time reviewing this document and we ask that while you review our presentation of this issue, you think about alternative capital for credit unions from a “Why not?” perspective. After all, out-of-the box thinking allowed credit unions to progress into the dynamic institutions we appreciate and know today.

Reasons It Makes Sound Sense

NASCUS presents the attached white paper to demonstrate that there are models of alternative capital instruments that the credit union community can and should consider as alternative means to raise capital. The instruments presented enhance credit union capital adequacy and safety and soundness.

Each of the alternative capital instruments and arrangements discussed in this paper are designed specifically to preserve the not-for-profit, mutual, member-owned and cooperative structure of credit unions. Moreover, these instruments ensure that ownership interest remains with the members. As such, these instruments preserve the federal income tax exemption that credit unions have historically enjoyed.

The equity model instruments described in the attached paper qualify as equity capital balances under GAAP and, as such, provide a degree of permanence such that a sudden outflow of capital will not occur. The debt model instrument described provides similar benefits such that other regulators have recognized these instruments as capital for regulatory purposes. While providing a feasible means for augmenting capital, these instruments ensure that the capital structure of credit unions is not fundamentally changed and that the safety and soundness of the credit union community as a whole is preserved.

NASCUS firmly believes that these alternative capital instruments allow a feasible means to augment capital and should be studied and tested further to demonstrate their market viability. We believe also that each model presents strong reasoning to examine and make appropriate changes to the definition of net worth in the Federal Credit Union Act to include other forms of capital.

Models of Alternative Capital Instruments

Background

Since the passage of the Credit Union Membership Access Act of 1998, and the NCUA's promulgation of the prompt corrective action regulations (PCA Regulations), credit union leaders have loudly decried the "PCA trap." These leaders argue that successful member service inevitably leads to asset growth; rapid asset growth results in diminished capital ratios; the PCA minimums (which are higher than those for banks and thrifts) mean that growth and member service have to be curtailed.

In trying to escape this trap, some credit union boards and their management teams have suggested that the credit union turn to a state charter and private share insurance. Others have suggested conversion to a mutual savings bank, while some have recommended that credit unions be permitted to issue one or more forms of alternative capital instruments that would receive recognition for regulatory capital purposes. In fact, many credit unions that have sought to convert to a mutual savings bank charter in recent memory have cited lack of access to capital alternatives as a rationale for conversion.

Unlike other financial institutions, credit unions have been able to increase their capital only by retaining a portion of their net earnings. For the first eight decades of their existence, American credit unions generally were not subject to capital ratio requirements and their regulators instead required them to add to retained earnings each quarter. As a result of the capital adequacy ratios that were imposed in 1998, most federally insured credit unions must maintain a minimum of 7% "net worth" or fall below the well-capitalized category and face increased regulatory requirements.

Unlike definitions associated with generally accepted accounting principles, the statutory definition of a federally insured credit union's "net worth" includes only the credit union's retained earnings.¹ The statute presumably omits any reference to any form of capital instrument because credit unions do not increase their capital by issuing common stock or taking advantage of other capital enhancement techniques generally available to banks and thrifts. They do not currently issue capital instruments because such instruments would have no regulatory value and, for state-chartered credit unions, there is a fear that such instruments would jeopardize the credit union's federal income tax-exempt status under the Internal Revenue Code.

The credit union community has debated for several years whether or not credit unions can and should offer capital instruments. Most detractors cite their concern that such capital instruments, especially if issued to non-members, would nullify the tax-exempt status of credit unions. In 2004, the U.S. Government Accountability Office released a report finding no compelling need for alternative capital at that time. The GAO based its

¹ However, low-income credit unions are permitted also to include a form of uninsured subordinated debt (secondary capital) as part of their "net worth" when determining compliance with the requirements of the PCA Regulations.

finding on three broad areas of concern. First, the GAO felt that, although non-credit union system purchasers of alternative capital instruments would provide market discipline, the involvement of such “outside investors” could threaten the member-owned, cooperative structure of credit unions. Second, the GAO felt that “inside investors” could raise systemic risk concerns if weaker credit unions could bring down stronger credit unions due to alternative capital investments – the so-called “daisy-chain effect.” Third, the GAO felt there was no clear alternative capital model to study.

This paper seeks to address this last concern by presenting three alternative capital instrument models for credit unions to study. The first two models are equity capital instruments – one that raises funds from members only, the other from non-members. Both of the models are “debt” for federal income tax purposes, while being characterized as “equity” under generally accepted accounting principles. Banks and business corporations have successfully issued similar “hybrid” instruments for more than two decades.

Next, we present a subordinated debt model instrument, which, when properly structured, is treated by other FFIEC regulators as Tier 2 capital.

This paper argues that such model structures can and should be treated by the credit union community, Congress, and credit union regulators as regulatory capital. The models presented in this white paper are not meant to be exhaustive.

Competing Considerations – “Debt” for Tax Purposes, “Equity” for Accounting Purposes

Debt characterization – State-chartered credit unions are exempt from federal income taxes under Section 501(c)(14)(A) of the Internal Revenue Code. That section creates a three-pronged test for determining the tax exemption. Under one of those prongs, credit unions are barred from issuing “capital stock” if they wish to remain tax exempt.

Neither the Internal Revenue Code nor IRS regulations define “capital stock” for this purpose. The relatively few published court opinions on the subject suggest that a lack of certain features tends to make an instrument less like common stock or capital stock and more like debt. Some of the key features to avoid are (a) voting rights, (b) any holder’s right to put the instrument back to the issuer, and (c) appreciation in the instrument’s value in accordance with the issuer’s profitability.

Meanwhile, some of the key features that make an instrument look more like debt are (d) repayment of the face amount at a time certain (maturity) and (e) a rate of return tied to an external benchmark (rather than the issuer’s profitability). A preferred rate of return will also help bolster the debt argument. Taken together, these considerations are a key to assuring that the instrument would not to be characterized by the IRS as “capital stock.”

Equity – The applicable accounting literature reveals several key features of instruments that are treated as equity. The most salient of those features are (1) distributions at the discretion of the issuer, (2) no obligation on the part of the issuer to repay any amount

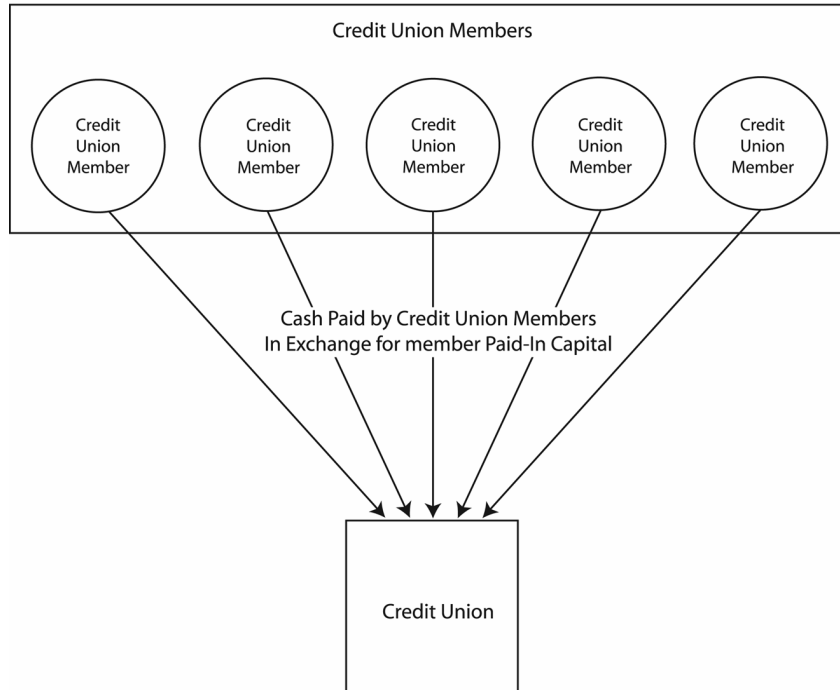
with respect to the holder's original contribution except, perhaps, upon liquidation; and (3) participation in the residual interests of the issuer (sharing in any profitability of the issuer upon liquidation). More explicit subordination of the claims of the instrument holders to the claims of creditors will also make an instrument more "equity-like."

Walking the line – The proposed hybrid instruments discussed below blend the above features, specifically:

- No voting rights;
- No put rights on the part of the holder;
- Redemption only at the discretion of the issuer, and then only at the face amount;
- Indefinite final maturity;
- Interest or dividends payable at a fixed rate rather than based on performance; and
- Subordination to claims of creditors and depositors.

Model One – Member Paid-In Capital – Key Characteristics

Member Paid-In Capital



The first hybrid capital instrument model could be called “Member Paid-In Capital” because of its similarity to instruments by the same name currently issued by corporate credit unions. The Member PIC issued by corporate credit unions is recognized by the NCUA as regulatory capital.²

With Member PIC, dividends (which are structured to be equivalent to interest) would be payable at a specified rate, most likely based on an external standard (e.g., LIBOR, Federal Home Loan Bank stock dividend rate). To satisfy GAAP equity accounting standards, dividends on PIC could be deferred at the credit union board’s discretion (e.g., the credit union could forgo a dividend payment if, immediately thereafter, the credit union would fail to meet one or more applicable capital ratios).

² Corporate credit unions are specifically exempt from the Federal Credit Union Act’s prompt corrective action requirements. Thus, there is no statutory “net worth definition” impediment to the NCUA’s recognition of alternative forms of instruments or accounts as capital for regulatory purposes.

Like equity instruments, Member PIC could not be “put” by the member back to the credit union – meaning that the member has no right to immediate redemption. However, the credit union could redeem Member PIC in a variety of situations at the credit union’s sole discretion. For example, the credit union could either call Member PIC or offer pro rata redemption. In addition, the credit union could choose, in its sole discretion, to honor a member’s redemption request under limited circumstances. Those limited circumstances most likely would include both a lengthy waiting period (*e.g.*, five years) and a requirement that, immediately following such redemption, the credit union would remain in compliance with all applicable capital ratios.

To give Member PIC two additional features typically present in GAAP equity instruments, it would have no stated maturity date and would be subordinate to other obligations and share accounts. Member PIC has sufficient GAAP equity characteristics that it would undoubtedly qualify as Tier 1 capital in the eyes of the other FFIEC regulatory agencies.

On the other hand, bolstering the argument that Member PIC would not be “capital stock” for tax purposes, it would not grant holders any voting rights in the credit union nor would it be transferable to non-members without the consent of the credit union. Further, bolstering Member PIC’s tax treatment as debt rather than “capital stock,” it would entitle holders to receive interest payments only and the face amount on liquidation of or redemption by the credit union. Member PIC’s priority also tends to support its debt characterization for tax purposes. In this regard, Member PIC would have priority over retained earnings, meaning that Member PIC would not suffer losses until all retained earnings had been exhausted to meet the credit union’s liabilities.

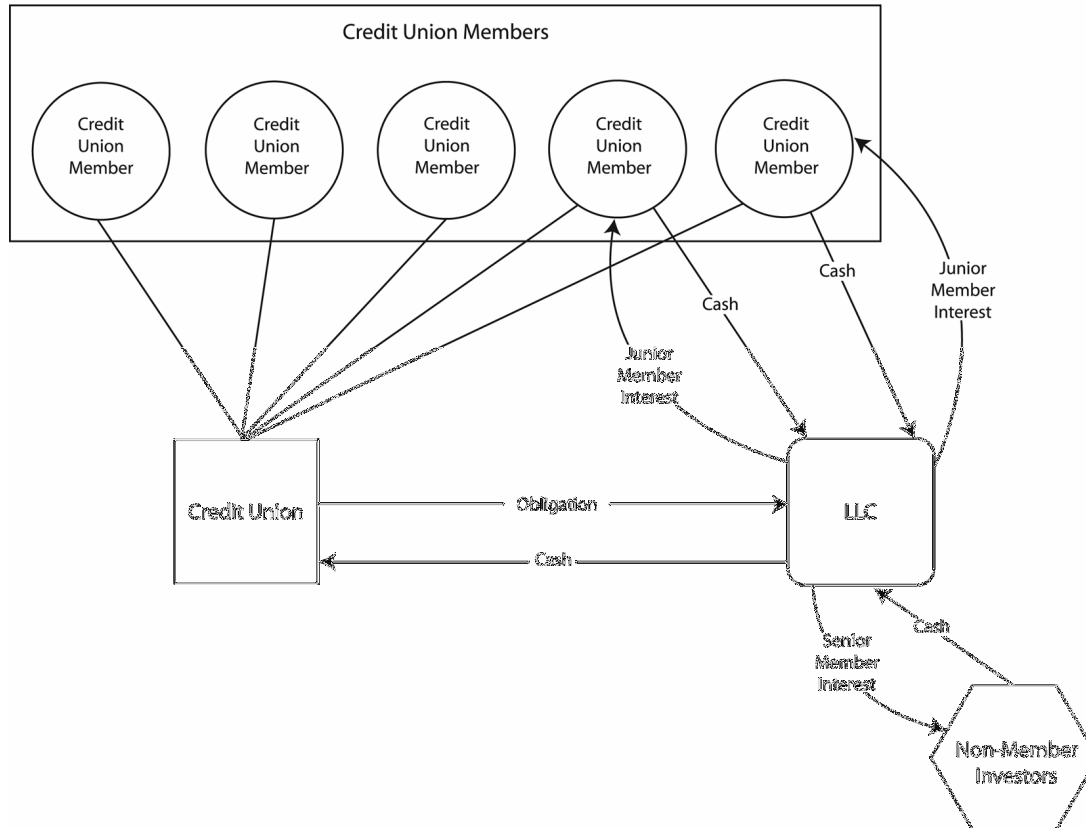
In 1997, the IRS issued a private letter ruling to the effect that U.S. Central Credit Union Member PIC with characteristics substantially similar to those above did not constitute capital stock for purposes of determining whether or not U.S. Central was exempt from federal income taxation under Section 501(c)(14)(A). Meanwhile, U.S. Central’s independent auditors have consistently treated such instruments as equity for GAAP purposes.

More recently, State Employees’ Credit Union of North Carolina issued Equity Shares, similar to Member PIC in the corporate credit union system. In May of 2005, the IRS issued a private letter ruling concluding that the Equity Shares issued by State Employees’ Credit Union, do not constitute “capital stock” within the meaning of section 501(c)(14)(A) of the Internal Revenue Code. This ruling indicated Equity Shares are merely a means of saving in that they grant neither a participating equity interest in the credit union nor any participation in the management of the credit union; accordingly, they do not impact the credit union’s tax exempt status under section 501(c)(14)(A) of the Internal Revenue Code.

Although the IRS private letter rulings apply only to PIC obligations issued by U.S. Central and to Equity Shares issued by State Employees’ Credit Union, respectively, and cannot be relied upon by any other party, it is reasonable to assume that the IRS would view similar private letter ruling requests in the same manner.

Model Two – Non-Member Paid-In Capital – Key Characteristics

Non-Member Paid-In Capital



The second hybrid capital instrument model is designed to obtain capital from outside the group of the credit union's members, and is thus called "Non-Member PIC." The non-members have only an indirect interest in the credit union and never become members.

Under the model, the credit union would first cause a limited liability company (or, LLC) to be formed. The initial contributors to the LLC's capital (and, thus, its initial owners) would be a limited number (e.g., seven to ten) of current individual members of the credit union, most likely officers or directors of the credit union. These individuals would contribute at least 3 percent of the proposed total capital of the LLC (i.e., the total capital to be contributed to the credit union), in exchange for 100 percent of the "voting junior interests" to be issued by the LLC. The LLC would obtain the remaining 97 percent of its capital by issuing 100 percent of its "non-voting senior interests" to persons not necessarily affiliated with the credit union. The LLC would be treated as a partnership for federal income tax purposes.

The LLC would then become a member of the credit union and purchase a special share certificate with many of the features outlined above for Member PIC (the "Obligation"). Despite its financial interest in the credit union, the LLC would have but one vote on matters coming before the credit union members for a vote. Meanwhile, the voting control of the LLC would be vested solely in the holders of the voting junior interests. The only exception would be a limited voting right for the holders of the non-voting senior interests in the event that the credit union failed to pay interest to the LLC for an extended period (e.g., three years).

The credit union would pay interest on the Obligation to the LLC at a specified preferred rate. The LLC, in turn, would pass on all or substantially all of its income from the Obligation to the holders of the LLC's non-voting senior interests. Further, interest would have to be paid in full to the holders of the non-voting senior interests before any interest could be paid to the holders of the voting junior interests. Interest on the Obligation could be deferred, but deferred interest would compound at a specified rate. To overcome the Obligation's subordination and the lack of voting rights associated with the non-voting senior interests, the rate of return on both instruments would have to be fairly attractive to non-members of the credit union.

While the Obligation would have no stated maturity date, it would be callable by the credit union at any time after five years following issuance.

This structure is an adaptation of trust preferred securities that bank holding companies have routinely issued since 1987, and which is recognized as Tier 1 capital by other FFIEC regulatory agencies.

In 1997, the IRS issued a private letter ruling to U.S. Central Credit Union to the effect that an instrument involving an arrangement substantially similar to that above, pursuant to which U.S. Central could raise capital from non-members, would not constitute capital stock for purposes of determining whether or not U.S. Central was exempt from federal income taxation under Section 501(c)(14)(A). For business reasons, U.S. Central has not, however, ever raised capital from non-members under this or any other arrangement.

Model Three – Subordinated Debt

In addition to the two hybrid instruments described above, it must be acknowledged that other FFIEC regulatory agencies recognize subordinated debt instruments as valuable capital supplements for the banks and thrifts they supervise. Under such agencies' regulations, in order to qualify as Tier 2 capital, subordinated debt must:

1. Be unsecured, i.e., not supported by pledged assets;
2. Be "subordinated," or "junior" to the claims of holders of credit union share accounts;
3. Not be insured by the FDIC; no protection in the event of insolvency;
4. Not contain put options (i.e., provisions that permit holders to accelerate the payment of principal prior to maturity);
5. Not be credit-sensitive (i.e., not make increased interest payments in near-default situations); and
6. Have an original weighted average maturity of no less than 5 years. Issues with a remaining maturity of between 4 and 5 years are weighted to be counted as capital at 80% of face value; between 3-4 years at 60%; between 2-3 years at 40%; between 1-2 years at 20 percent. Issues with remaining maturity of less than one year receive a 0 % weight.

The amount of subordinated debt (plus intermediate-term preferred stock) that qualifies as Tier 2 capital cannot exceed 50% of Tier 1 capital.

The Federal Credit Union Act's definition of "net worth" includes a form of uninsured subordinated debt (secondary capital) for low-income credit unions, as defined in such Act. The authors of this paper believe the Federal Credit Union Act should be amended to include such instruments as regulatory capital.

Conclusion

Thank you for reviewing the alternative capital instruments presented in this white paper. As mentioned, we created this paper, in part, to address the GAO Report that stated there was no clear alternative capital model to study. In addition, this paper provides an opportunity to address concerns in the credit union community about alternative capital.

NASCUS firmly believes that credit unions should have access to alternative capital and that it can be done in a safe and sound manner. We present these models to the credit union community for study and we welcome feedback on the models presented.

The models in this paper are structured to preserve the not-for-profit, mutual, member-owned cooperative structure of credit unions; they maintain the federal income tax exemption that credit unions enjoy. Two private letter rulings from the IRS have indicated that instruments structured similar to the equity models presented in this white paper are exempt from federal income taxation under Section 501(c)(14)(A). While the IRS private letter rulings apply only to PIC obligations issued by U.S. Central and to Equity Shares issued by State Employees' Credit Union, respectively, and cannot be relied upon by

any other party, it is reasonable to assume that the IRS would view similar private letter ruling requests in the same manner.

This paper does not address regulatory authority, nor does it discuss state and federal law as it concerns alternative capital. Not every credit union may have regulatory or statutory authority to offer these instruments.

Our research indicates that only ten states have laws allowing state-chartered credit unions access to alternative capital³. When state law provides for alternative capital, the state regulatory authority must allow for it in its rules and regulations. Additionally, before credit unions may consider alternative capital for PCA purposes, an amendment to Section 216(o)(2) of the Federal Credit Union Act (12 U.S.C. 1790d(o)(2)(A)) is required to include more than retained earnings in the definition of net worth.

These models, structured correctly, preserve the interest of members and the equity capital models presented do not change the capital structure of the credit union system. Additionally, they provide a feasible means for credit unions to grow capital, enhancing the safety and soundness of the credit union system. Further, they provide a degree of permanence so credit unions are not faced with a sudden outflow of capital.

The models presented are viable in the marketplace and with proper disclosures, they provide a safe means for members, or potentially non members, to increase returns—an important goal for consumers in today's marketplace. Further, the equity model instruments described in the paper qualify as equity capital balances under GAAP, while the debt model instrument is recognized by some FFIEC regulators as capital for regulatory purposes.

NASCUS firmly believes that credit unions should have access to alternative capital. We welcome your feedback.

³ *NASCUS Profile*, 2003-2004 Edition