AMERICA'S MUTUAL BANKS
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Mr. David Riley
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Dear Mr. Riley:

America's Mutual Banks ("AMB") is submitting this letter as a follow up to our conversation regarding alternative capital instruments for mutual institutions. As we discussed, retained earnings is the primary method by which mutual institutions can raise capital. Although mutuals are generally some of the highest capitalized banking institutions insured by the FDIC, AMB believes it is imperative to establish other methods by which mutuals can raise Tier 1 capital. Such capital can be used to expand operations, act as a buffer against the continued downturn in the economy, finance acquisitions and for other corporate purposes.

Historical Capitalization of Mutuals

While retained earnings is the primary method to raise capital, there is precedent for a debt-like instrument to count as Tier 1 capital for a mutual institution. The OCC's regulations at 12 C.F.R. § 143.3, relating to the chartering of a de novo mutual federal savings association, provide that a de novo association must have an initial capitalization of at least $2.0 million of "pledged savings accounts." Pledged savings accounts are accounts that are pledged by the institution's founders and act as the initial capital. The OCC's regulations at 12 C.F.R. § 167.5 include pledged accounts as "core capital." That section provides that the definition of core capital includes "nonwithdrawable accounts and pledged deposits of mutual savings associations (excluding any treasury shares held by the savings association) meeting the criteria of regulations and memoranda of the OCC to the extent that such accounts or deposits have no fixed maturity date, cannot be withdrawn at the option of the accountholder, and do not earn interest that carries over to subsequent periods." Thus, historically, interest paying instruments with certain debt like features but no claim by the holder for withdrawal have been included in the definition of core capital.

In addition to non-withdrawable pledged accounts, the Home Owners' Loan Act and the OCC's regulations also permit "mutual capital certificates" as a form of capital for mutual institutions. OCC regulations found at 12 C.F.R. § 163.74 provide that a mutual capital certificate must meet the following requirements:

> (i) Be subordinate to all claims against the association having the same priority as savings accounts, savings certificates, debt obligations or any higher priority;

(ii) Not be eligible for use as collateral for any loan made by the issuing association;

(iii) Constitute a claim in liquidation not exceeding the face value plus accrued dividends of the certificates, on the general reserves, surplus and undivided profits of the association remaining after the payment in full of all savings accounts, savings certificates and debt obligations;

(iv) Be entitled to the payment of dividends, which may be fixed, variable, participating, or cumulative, or any combination thereof, only if, when and as declared by the association's board of directors out of funds legally available for that purpose, provided that no dividend may be declared or paid without the approval of the appropriate Federal banking agency if such payment would cause the association to fail to meet its regulatory capital requirements and provided further that no dividend may be paid if such payment would constitute a violation of 12 U.S.C. 1828(b);

(v) Not be redeemable, except: (A) where the dollar weighted average term of each issue of mutual capital certificates to be redeemed is seven years or more and redemption is to be made pursuant to a redemption schedule; (B) in the event of a merger, consolidation or reorganization approved by the appropriate Federal banking agency; or (C) where the funds for redemption are raised by the issuance of mutual capital certificates approved pursuant to this section, or in conjunction with the issuance of capital stock pursuant to part 192 of this chapter: Provided, that mandatory redemption shall not be required; that mutual capital certificates shall not be redeemable on the demand or at the option of the holder; and that mutual capital certificates shall not receive, benefit from, be credited with or otherwise be entitled to or due payments in or for redemption if such payments would cause the association to fail to meet its regulatory capital requirements; And Provided further, for the purposes of this paragraph, the “dollar weighted average term” of an issue of mutual capital certificates shall be the sum of the products calculated for each year that the mutual capital certificates in the issue have been redeemed or are scheduled to be redeemed. Each product shall be calculated by multiplying the number of years of each mutual capital certificate of a given term by a fraction, the numerator of which shall be the total dollar amount of each mutual capital certificate in the issue with the same term and the denominator of which shall be the total dollar amount of mutual capital certificates in the entire issue;

(vi) Not have preemptive rights;

(vii) Not have voting rights, except that an association may provide for voting rights if: (A) The savings association fails to pay dividends for a minimum of three consecutive dividend periods, and then the holders of the class or classes of

> mutual capital certificates granted such voting rights, and voting as a single class, with one vote for each outstanding certificate, may elect by a majority vote a maximum of one-third of the association's board of directors, the directors so elected to serve until the next annual meeting of the association succeeding the payment of all current and past dividends; (B) Any merger, consolidation, or reorganization (except in a supervisory case) is sought to be authorized, where the issuing association is not the survivor, provided that the regulatory capital of the resulting association available for payment of any class of mutual capital certificate on liquidation is less than the regulatory capital available for such class prior to the merger, consolidation, or reorganization; (C) Any action is sought to be authorized which would create any class of mutual capital certificates having a preference or priority over an outstanding class or classes of mutual capital certificates; (D) Any action is sought to be authorized which would adversely change the specific terms of any class of mutual capital certificates; (E) Action is sought to be authorized which would increase the number of a class of mutual capital certificates, or the number of a class of mutual capital certificates ranking prior to or on parity with another class of mutual capital certificates; or (F) Action is sought which would authorize the issuance of an additional class or classes of mutual capital certificates without the association having met specific financial standards;
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> (viii) Not constitute an obligation of the association and shall confer no rights which would give rise to any claim of or action for default;
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> (ix) Not be convertible into any account, security, or interest, except that mutual capital certificates may be surrendered in exchange for preferred stock issued in connection with the conversion of the issuing savings association to the stock form pursuant to part 192 of this chapter, provided that the preferred stock shall have substantially the same voting rights, designations, preferences and relative, participating optional, or other special rights, and qualifications, limitations, and restrictions, as the mutual capital certificates exchanged for the preferred stock; and
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> (x) Provide for charging of losses after the exhaustion of all other items in the regulatory capital account.

Mutual capital certificates are included as supplementary (Tier 2) capital under the OCC’s regulations at 12 C.F.R. § 167.5(b)(1)(ii).

<u>Credit Union Proposals</u>

Credit unions are mutual institutions similar to mutual savings associations. In 2005, the National Association of State Credit Union Supervisors (“NASCUS”) issued a white paper proposing alternative capital instruments for credit unions. The white paper focused on creating capital instruments that complied with IRS rules necessary for credit unions to remain tax exempt. One prong of the IRS test is the prohibition against credit unions issuing "capital stock." The white paper proposed a hybrid instrument that combined features of both debt and equity instruments. The debt features included no voting rights, the inability of the holder to put the instrument back to the issuer, the ability of the issuer to redeem the instrument at its sole discretion, but only at the face amount and the payment of interest or dividends at a fixed rate rather than tied to performance. The equity features of the instrument included no maturity date and claims of the holders are subordinate to claims of creditors and depositors.

The NASCUS white paper noted that in 1997, the IRS issued a private letter ruling to a U.S. credit union stating that instruments with characteristics substantially similar to those set forth above would not be considered capital stock. The IRS came to this conclusion on the basis that the proposed "equity shares" only provided discretionary interest payments until redemption, did not provide for any appreciation or equity participation and did not grant the holder any voting rights or participation in the management of the credit union. While the IRS determined that the equity shares did not constitute capital stock, the credit union's independent auditors treated the instruments as equity.

Similarly, in Canada, a credit union is permitted to issue Class B Investment Shares which are included as Tier 1 capital under Canadian capital requirements. These shares are non-voting, redeemable at the sole discretion of the Board, non-cumulative and dividends and optional redemption are subject to compliance with capital, liquidity and operational regulatory requirements. Under Canadian rules if Tier 2 capital exceeds Tier 1 capital all Tier 2 capital is disqualified from regulatory inclusion as capital. Otherwise, only the amount of Tier 2 capital equal to Tier 1 capital can be included in meeting regulatory requirements.

<u>AMB Proposal</u>

Based on the above, an alternative capital instrument for mutuals must have enough characteristics under GAAP to qualify as Tier 1 nonwithdrawable capital, but yet contain no features that are inconsistent with the mutual nature of the organization or jeopardize the tax deductibility of the interest payments. The deductibility of the interest payments is particularly important to be able to offer an instrument that is economically attractive to both the issuer and the investor. In this regard then, AMB would propose the establishment of a non-withdrawable investment certificate that would have the following characteristics:

- No voting rights, except that holders of the instruments have the right to elect two directors upon the sixth missed interest payment, upon a change of control and upon changes in the capital structure of the bank;
- No holder may put the instrument back to the issuer;
- Redemption solely at the issuer's discretion;
- Interest payable may be fixed or variable or tied to an index;

- Interest is payable if and when declared by the board;
- Perpetual/No maturity date;
- Repayment is subordinate to the claims of creditors and depositors;
- Convertible into shares of common stock upon a mutual to stock conversion of the bank on a dollar for dollar basis.

Payment of Interest

Interest would be paid if, and when, declared by the board. AMB would propose that the FDIC permit the payment of interest based on whether the bank has sufficient earnings as follows: the interest would be in the nature of income payments and be paid in an amount up to the lesser of the stated rate or 50% of the bank's net income, provided that the bank remains adequately capitalized following the payment of interest. If the bank would not be adequately capitalized following the payment of interest, then the bank must receive prior regulatory approval before making the payment and then only if such payment would not bring the bank below minimum capital levels.

AMB would also propose that the instrument allow for cumulative interest payments in the event that the bank was not able to pay the stated rate on the certificate. AMB understands that cumulative dividends are not permitted as Tier 1 capital for stock institutions. There is good reason for this, however, because if the dividends accumulate for a long enough period of time in a stock institution, there is the potential that the common shareholders could put pressure on the board to act in a manner inconsistent with the business plan, safety and soundness principles and/or fiduciary duties. Common stockholders with voting control of the institution would be tempted to act imprudently to protect their junior position. This would not be the case in a mutual, since there are no "owners" that would perceive the dilution in the value of their economic stake. In a mutual all the deposit accounts would be senior to the investment certificates and in any event the overwhelming number of accounts are fully insured. Finally, while member-depositors do have inchoate claims to any surplus remaining on liquidation, these claims are of negligible value and most depositor members are unaware they exist. Thus, there are very few members who would perceive any reason to force imprudent action with respect to the treatment of cumulated interest. Even in the remote chance a misperception could exist that indefinite cumulated interest payments would have an adverse effect on the economic stake of member depositors they have little practical governance power unlike voting common stockholders to influence the Board. AMB believes that the cumulative interest feature will not raise any quality of capital concerns, while making the instruments more attractive in the market.

Voting Rights

Although the instruments would not provide for voting rights, the holders would be able to elect two directors upon the sixth missed periodic payment. The right to elect directors upon the failure to pay interest is the same right given to the U.S. Treasury by debt and equity instruments issued by participating banks pursuant to the Capital Purchase Program. These instruments were deemed to be Tier 1 capital by the Federal Reserve.

In addition to the above, the holders of the certificates would be able to vote as a class on any merger, consolidation, or reorganization (except in a supervisory case) where the issuing association is not the survivor; any action which would create any class of certificates having a preference or priority over an outstanding class or classes of non-withdrawable investment certificates; any action which would adversely change the specific terms of any class of non-withdrawable investment certificates; any action which would increase the number of a class of non-withdrawable investment certificates, or the number of a class of non-withdrawable investment certificates ranking prior to or on parity with another class of non-withdrawable investment certificates; or any action which would authorize the issuance of an additional class or classes of non-withdrawable investment certificates without the bank having met specific financial standards as set forth in the certificates. These features are consistent with Mutual Capital Certificates.

Conversion

Upon a mutual to stock conversion of the bank, the non-withdrawable investment certificates would be converted into common stock of the bank on a dollar for dollar basis. For example, if the bank had $10 million of non-withdrawable investment certificates outstanding prior to conversion, then such certificates would convert into $10 million of common shares upon the conversion of the bank, regardless of the appraised value of the bank pursuant to the conversion regulations. In this regard, then, the value of the certificates remains fixed and the holders will not participate in any increase in equity value of the bank that could occur after the issuance of the certificates and prior to a conversion.

Collins Amendment

Section 171 of the Dodd-Frank Act, also known as the "Collins Amendment", requires the appropriate banking agencies to establish minimum leverage and risk-based capital requirements for depository institutions and their holding companies that are, among other things, not qualitatively lower than the generally applicable leverage and risk-based capital requirements that were in effect for insured depository institutions on the date of enactment of the Dodd-Frank Act. This means that the components of capital cannot be qualitatively lower than those in effect on the date of enactment. For mutual savings associations, the OCC's regulations already permit non-withdrawable deposit accounts to count towards Tier 1 capital. Further, the regulations provide some flexibility in that they permit the OCC to develop new forms of non-withdrawable certificates. In this regard, 12 C.F.R. § 167.5 states that core capital includes "nonwithdrawable accounts and pledged deposits of mutual savings associations meeting the criteria of regulations and memoranda of the OCC..." Thus, the OCC is permitted to develop criteria for new forms of non-withdrawable capital instruments that are deemed Tier 1 capital. The instruments proposed by AMB meet two of the three tests stated in Section 167.5 in that they would not have a fixed maturity date and cannot be withdrawn at the option of the accountholder. AMB requests that the agencies consider the cumulative payment of interest feature for the reasons set forth above. AMB believes that such a feature, although not in strict compliance with the third test of that section (i.e., the instruments do not earn interest that carries over to subsequent periods) AMB believes that such a feature would improve substantially the marketability of the instruments while not affecting the quality of capital of the instrument.

AMB believes that the development of a non-withdrawable investment certificate will enhance significantly the continued vitality of the mutual banking industry and increase the capital cushion protecting the Federal deposit fund. AMB welcomes the opportunity to continue our discussion on this matter. You may contact the undersigned at your earliest convenience.

Very truly yours,

Douglas P. Faucette
Counsel to America's Mutual Banks