Alternative Capital for U.S. Credit Unions? A Review and Extension of Evidence Regarding Public Policy Reform

Robert F. Hoel, PhD
Professor Emeritus of Business,
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Deeply embedded in the credit union tradition is an ongoing search for better ways to understand and serve credit union members. Open inquiry, the free flow of ideas, and debate are essential parts of the true democratic process.

The Filene Research Institute is a 501(c)(3) not-for-profit research organization dedicated to scientific and thoughtful analysis about issues affecting the future of consumer finance. Through independent research and innovation programs the Institute examines issues vital to the future of credit unions.

Progress is the constant replacing of the best there is with something still better!

— Edward A. Filene

Ideas grow through thoughtful and scientific analysis of top-priority consumer, public policy, and credit union competitive issues. Researchers are given considerable latitude in their exploration and studies of these high-priority issues.

The Institute is governed by an Administrative Board made up of the credit union industry's top leaders. Research topics and priorities are set by the Research Council, a select group of credit union CEOs, and the Filene Research Fellows, a blue ribbon panel of academic experts. Innovation programs are developed in part by Filene i^3, an assembly of credit union executives screened for entrepreneurial competencies.

The name of the Institute honors Edward A. Filene, the "father of the U.S. credit union movement." Filene was an innovative leader who relied on insightful research and analysis when encouraging credit union development.

Since its founding in 1989, the Institute has worked with over one hundred academic institutions and published hundreds of research studies. The entire research library is available online at www.filene.org.

Acknowledgments

This research was inspired by the National Association of State Credit Union Supervisors, which urged the Filene Research Institute to synthesize existing research about alternative capital and to fill in informational and analytical gaps. This project was funded in part by a generous grant from the Corporate Credit Union Network.

The author thanks the many researchers who have examined alternative capital issues in recent years and whose findings are cited in this report. Also, appreciation is extended to the dozens of experts in the credit union movement and the banking industry who generously shared their knowledge about alternative capital needs and mechanisms. Their organizations include Abbott Laboratories Employees Credit Union, American Airlines Federal Credit Union, American Share Insurance, Association of Corporate Credit Unions, California Credit Union League, Credit Union National Association, CUNA Mutual Group, National Association of Community Development Credit Unions, National Association of State Credit Union Supervisors, National Association of Federal Credit Unions, State Employees' Credit Union of North Carolina, and the World Council of Credit Unions.

My special thanks go to William E. Jackson III, professor of management and Smith Foundation Chair of Business Integrity at the University of Alabama, and to George Hofheimer, chief research officer at the Filene Research Institute, for their many insights during this research effort. Also, I wish to thank Josey Siegenthaler of the Filene Research Institute and Alissa Bazsali for their invaluable assistance in preparing this report.

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Executive Summary and Commentary

By George A. Hofheimer,
Chief Research Officer

Autumn is a lovely time of year where I live. The leaves are changing, mornings and evenings are brisk, all those darn mosquitoes are going into hibernation, and animals are preparing for winter. One of my most enjoyable things to observe during this time of year is the wily squirrel—in particular, squirrels that make their homes near oak trees. These squirrels fill their mouths with acorns to the point of overflow and then hide the tasty morsels for the lean months. The squirrels work hard going back and forth between their only food source and their secret lair so that they have enough food to last the season. I always think to myself, how many acorns do these tiny creatures really need? The answer came to me when Bob Hoel, the author of this study, handed me this report.

For some time I could not quite determine why credit unions needed alternative sources of capital. Academics, consultants, credit union executives, and economists will likely tell you credit unions are "overcapitalized."[1] So if credit unions have more than enough capital, why do they need to find alternative sources of capital? Then my mind zipped back to those kinetic squirrels. The reason those squirrels are collecting so many acorns is similar to why credit unions are collecting so much capital: Each group has only one source of sustenance. For squirrels it is the oak tree, and for credit unions it is retained earnings. Psychologists refer to this type of behavior as hoarding, and while it is not a common human behavior, hoarding is a common response to fear, whether fear of danger or the simple fear of *a shortage of some good*. Therefore, with alternative sources of capital, credit unions may be paradoxically more efficient with their precious capital.

With this added clarity it is now essential to turn our attention away from squirrels so that we may explore the three fundamental research questions of this report:

- Is it in the public interest to permit U.S credit unions greater access to alternative capital sources?
- Can credit unions use alternative capital to expand their capital bases in a way that will not dilute their cooperative ownership, values, and governance structure?
- If so, what alternative capital mechanisms would be most appropriate and feasible?

1 In late 2007, the Filene Research Institute released a study entitled *Is the U.S. Credit Union Industry Overcapitalized? An Empirical Examination,* by William E. Jackson III.

What Did the Researcher Discover?

Hoel reviews existing literature in the fields of credit unions, capital formation, and public policy and provides the following eight key research conclusions:

- It is in the public interest to permit credit unions greater access to alternative capital sources.
- Federal and state laws and regulations should be amended to permit credit unions to obtain alternative capital.
- Credit unions can expand their capital bases by using alternative capital in ways that will not dilute their cooperative ownership, values, and governance structure.
- Several different mechanisms for raising alternative capital are appropriate and feasible. Some of the most promising involve obtaining alternative capital from outside investors, and others involve acquiring special long-term deposits from credit union members.
- A broad menu of alternative capital options would best serve credit unions, their members, and the general public. There is no single method that is best for all credit unions seeking alternative capital.
- It would be appropriate for credit union regulators to review and approve a credit union's alternative capital plan and mechanisms prior to its issuance of alternative capital instruments.
- Though many credit unions may not wish to seek alternative capital now, having the power to do so would benefit them by allowing them to conduct their business with the confidence that, if necessary, they could build capital in a variety of ways beyond the slow retained-earnings approach.
- Steps should be taken promptly to repeal or reform statutes and regulations that prohibit credit unions from obtaining alternative capital. No compelling reasons to delay were uncovered during the course of this research.

Practical Implications

One of the most extraordinary issues related to this topic is the dearth of capital formation tools at the disposal of most U.S. credit unions. Cooperatives and credit unions around the world have figured out how to access alternative forms of capital without diluting the core ownership structure of their organization. Additionally, investor-owned financial services firms have seemingly unlimited options and access to capital. This puts U.S. credit unions at a potential disadvantage because they operate in an environment where financial services consumers are demanding more delivery channels, higher levels of service, and more product choices.

Since most credit unions reading this report do not have access to alternative sources of capital, one of the most practical things you can do with this document is educate yourself and policymakers about the how, why, when, and what of alternative capital issues. This report certainly covers these issues in great detail.

Finally, as I write this executive summary, autumn is setting in, and the squirrels, like most credit unions, are starting their planning season. This study, therefore, may be a nice springboard to discuss issues related to credit union capital at your institution. Every so often a report is released that presents a comprehensive look at an issue that is critical to the future of your institution. I therefore urge you to share (not hoard) this report with your credit union colleagues.

About the Author

Robert F. Hoel, PhD

Robert F. Hoel, PhD, is the Filene Fellow in Residence at the Filene Research Institute. He frequently speaks about credit union challenges and opportunities at meetings for credit union leaders, regulators, and auditors, among others. He has spoken at conferences and conventions in all 50 states as well as in Canada, Europe, Africa, Asia, Australia, and South America.

Prior to joining Filene, Dr. Hoel was a professor of business and the chairman of the department of marketing at Colorado State University. He received Colorado State University's Outstanding Business Professor Award on three separate occasions.

His primary research interests are in the areas of financial institutions, marketing strategy, and consumer analysis. His research has been reported extensively in academic and industry journals, and he has served as a consultant to a wide range of private-sector and government organizations. He received his PhD from the University of Minnesota, an MBA from Indiana University, and a BA from Hamline University. Currently, he is a member of the national examining committee for the Certified Credit Union Executive program, the capitalization program committee of the National Federation of Community Development Credit Unions, and the credit policies committee at Great Wisconsin Credit Union.

CHAPTER 1
A Capital Formation Anomaly

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 served if U.S. credit unions had access to more capital formation options.

Financial institutions need adequate capital to serve their patrons and continue operating in a safe and sound manner. Because capital needs increase as financial institutions grow and enhance their product and service offerings, new avenues for capital formation have opened for them during the past 50 years. Enlightened government policies on capital alternatives have emerged worldwide. New capital instruments have been developed and deployed.

Legislation and regulations regarding capital for U.S. credit unions, however, have not been updated to allow these credit unions access to modern capital options. Their capital structures remind analysts of balance sheets of the 1950s. Laws and regulations require most of these member-owned, not-for-profit cooperatives to grow capital almost exclusively via retained earnings.

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 wide 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 served if U.S. credit unions had access to more capital formation options.

Capital: What Is It?

The term "capital" is frequently misunderstood. Capital is not something that is locked in a large blue fireproof box and placed in a black vault. It is not a physical entity. Rather, it is an economic and financial construct. In its simplest form, capital is a firm's assets that remain after subtracting its liabilities. In the event of financial difficulties, the claims of owners of capital are subordinated to other claims.

Paletta illustrates a classic function of capital in a financial institution:

> *A bank's capital, essentially calculated by subtracting liabilities from assets, is its last line of defense against collapse. A bank might have $100 million in loans, financed by $90 million in deposits, which are liabilities. In this case, capital would equal 10% of assets, sufficient to absorb losses up to $10 million without endangering the bank's ability to repay deposits.* (Paletta 2006, C3)

Of course, today's financial institutions are more complex. Liabilities include more than deposits. External deposit insurers typically have claims in the case of collapse. Also, by contract, the claims associated with some liabilities and equity-like instruments may be deeply subordinated to other claims. Deeply subordinated claims are called "alternative capital" and protect the claims of depositors and others, much like owner equity does.

Again, it is important to remember that capital in most cases is not physically segregated from other funds. If a financial institution receives infusions of capital, those new funds are commingled with other funds and used to make loans, acquire assets, and conduct the affairs of the institution.

Capital: An Evolving Concept

History shows that capital in financial institutions plays a critical role in stabilizing a nation's economy and protecting taxpayers, who may be required to bail out failing financial institutions. The problems of U.S. banks and thrifts during the 1980s and early 1990s are recent examples. A present-day example is the subprime mortgage difficulties encountered by financial intermediaries. Because an increasingly global economy is destined to adversely affect many employers and local economies, the adequate capitalization of financial institutions has rarely been more important.

It is important to remember that capital in most cases is not physically segregated from other funds.

Not surprisingly, definitions of capital have evolved as economies and financial markets have matured and evolved themselves. Historically, capital was narrowly defined as owner equity, which is subordinated to the claims of almost all creditors and government authorities. Now, however, capital typically includes long-term debt and other financial instruments and funds that are subordinated to almost all claims other than those of equity owners. Terms like "alternative capital," "Tier 2 capital," "supplementary capital," and "secondary capital" all refer to these other capital sources. For U.S. credit unions, secondary capital and alternative capital are broadly

defined as "capital generated from sources other than retained earnings" (Kwon and Lee 2006, 7–8).

Because banks, cooperatives, and credit unions outside the United States can expand their capital bases through a wide variety of means, it is not surprising that they often express amazement at the comparatively primitive capital structures of U.S. credit unions. Many financial institutions that compete with U.S. credit unions are no doubt pleased by the capital acquisition restrictions placed on credit unions. Less credit union capital means less competition.

Capital: A Filene Research Priority

Capital formation and credit union safety and soundness issues have long been research priorities at the Filene Research Institute. Scholars at leading universities and other experts have contributed original research to six Filene publications on capital. Other Filene reports have dealt with a wide variety of related safety and soundness concerns.

The subsequent chapters of this report reference these studies and summarize many of their key findings. Readers are encouraged to review these reports for full details on methodology and findings.

Research Purpose, Questions, and General Methodology

This report examines alternative capital options for U.S. credit unions and proposes methods for expanding their capital acquisition alternatives. It synthesizes findings from previous Filene Research Institute reports and other sources and fills informational and analytic gaps. It seeks credit union capital alternatives that serve the public interest and the best interests of credit union members.

More specifically, this report explores three questions regarding the issue of alternative capital in U.S. credit unions:

- Is it in the public interest to permit U.S. credit unions greater access to alternative capital sources?
- Can credit unions use alternative capital to expand their capital bases in a way that will not dilute their cooperative ownership, values, and governance structure?
- If so, what alternative capital mechanisms would be most appropriate and feasible?

CHAPTER 2
The Vital Role of Credit Union Capital

Capital serves as a cushion for credit unions. Because of standards set by the Credit Union Membership Access Act and the National Credit Union Administration, credit unions are now required to have more capital than banks do to qualify as "well-capitalized."

Capital serves as a cushion for credit unions and other financial institutions, allowing them to absorb operating, credit, and other losses. It also protects deposit insurance funds, which assure depositors that all or portions of their savings will not be lost if the institution experiences major financial difficulties. Deposit insurance funds reimburse depositors only after the financial institution's capital has been depleted.

Deposit Insurance

In the case of most credit unions, the National Credit Union Share Insurance Fund (NCUSIF) insures total deposits (shares) of up to $100,000 for each member of a federally chartered credit union. In addition, retirement accounts (individual retirement accounts and Keogh accounts) are separately insured up to $250,000 per member.

Though most state-chartered credit unions are similarly insured by the NCUSIF, some states permit state-chartered credit unions to carry private deposit insurance in lieu of NCUSIF coverage. Sometimes NCUSIF- and privately insured credit unions purchase additional nonfederal insurance to cover deposits exceeding standard deposit insurance limits.

Credit union members, deposit insurers, and regulators share a strong interest in building and maintaining adequate levels of institutional capital: Members want their credit union to survive so they can continue to receive credit union benefits, and regulators and insurers want to insulate insurance funds from major losses.

Clearly, it is in the national interest for banks and credit unions to be adequately capitalized. Too many failures of financial institutions would destabilize the U.S. financial system. Furthermore, the federal government promises to support seriously depleted federal deposit insurance funds with the full faith and credit of the United States.

Evolution of Credit Union Capital Levels[2]

Until the 1970s, most credit unions operated with minimal capital. The belief was that, as member-owned cooperatives, credit unions should limit capital accumulation and instead emphasize the provision of attractive prices and quality services to members. Excess retained earnings were considered by many as contrary to the credit union's purpose, democratic nature, and philosophy of member control, the idea being that credit unions should return as much capital to members as possible.

In the early 1980s, the credit union movement established the National Credit Union Capitalization Commission to study capital issues facing credit unions and corporate credit unions. One key output was a philosophical document declaring that raising capital levels at natural-person credit unions[3] is a legitimate undertaking that can enhance long-term benefits for members. The document helped establish the movement's view that it is not anti-cooperative to build net worth in credit unions.

In the mid-1980s, the National Credit Union Administration (NCUA) reinforced perceptions of a need to grow capital when it introduced the CAMEL approach in its regulatory processes. (CAMEL was already being used by some state credit union regulators.) The basic idea is to evaluate credit unions in five general areas, the first letters of which spell "CAMEL." The letter "C" stands for "capital." The NCUA set targets in the CAMEL matrix that exceeded capital levels possessed by credit unions at the time.

The belief was that, as member-owned cooperatives, credit unions should limit capital accumulation and instead emphasize the provision of attractive prices and quality services to members.

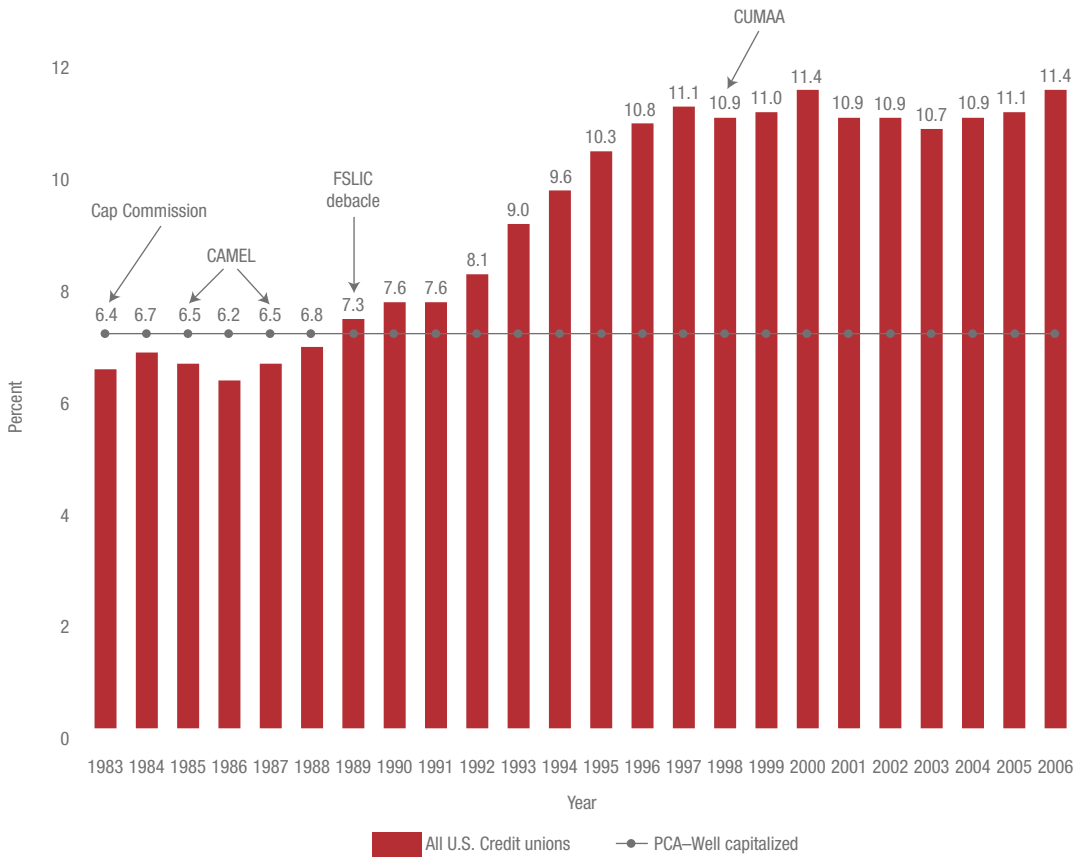
The Federal Savings and Loan Insurance Corporation (FSLIC) crisis in the late 1980s, coupled with the troubles at the Federal Deposit Insurance Corporation (FDIC), sent warning signals to federal and state regulators about capital adequacy at all financial institutions. Though credit unions experienced less financial difficulty than the bank and thrift industries, regulators became more zealous in their examination and supervision of credit unions, and they increased their pressure on credit unions to build capital (Wilcox 2005b, 2007).

2 This section draws heavily from Bill Hampel, "The Prospect of Alternative Capital," in *Managing Credit Union Capital: Subordinated Debt, Uninsured Deposits, and Other Secondary Sources* (Madison, WI: Filene Research Institute, 2004), 21–34.

3 A natural-person credit union serves individuals and families directly, while a corporate credit union serves other credit unions and credit union organizations.

Figure 1 shows credit union net worth ratios from 1983 to 2006. When the National Credit Union Capitalization Commission completed its work in 1983, the net worth ratio in credit unions was 6.4%, compared to previously typical ratios equal to or below 6%. The introduction of CAMEL helped keep capital levels above 6% for the remainder of the decade, even though credit unions were growing rapidly. Capital soared after the FSLIC debacle for a variety of reasons, including greater regulatory vigilance. Interestingly, the run-up in net worth ratios preceded the passage in 1998 of the Credit Union Membership Access Act (CUMAA), which explicitly defines capital adequacy levels. Since 1989, net worth ratios have exceeded the act's 7% requirement for a well-capitalized credit union, and since 1995 they have exceeded 10%.

Figure 1: Credit Union Net Capital to Assets—1983–2006



Source: CUNA Economics and Statistics.

CUMAA[4]

CUMAA imposed explicit net worth requirements on federally insured credit unions. Also, prompt corrective action (PCA) rules for credit unions failing to meet minimum standards were mandated. The act defines net worth, and it does so very narrowly. It forbids the use of alternative capital with few exceptions.

Unlike banks, credit unions now face *statutorily* defined capital levels. Bank regulators can adjust bank capital level requirements based on their knowledge of the banking industry. Credit union regulators cannot, because of CUMAA. Credit unions, with a few statutorily defined exceptions, are required by law to maintain 7% capital to qualify as well capitalized, while banks are required by their regulators to maintain 5%. Credit unions need 6% capital to qualify as adequately capitalized, while banks need 4%. Credit unions with less than 6% net worth are subject to PCAs that become increasingly severe as their net worth ratio falls.

Since 1989, net worth ratios have exceeded the act's 7% requirement for a well-capitalized credit union, and since 1995 they have exceeded 10%.

CUMAA divides credit unions into five categories: (1) standard, (2) complex, (3) low-income, (4) new, and (5) under a net worth restoration plan. Standard credit unions are by far the most prevalent. Based on their net worth ratios, CUMAA further classifies credit unions as (1) well capitalized, (2) adequately capitalized, (3) undercapitalized, (4) significantly undercapitalized, and (5) critically undercapitalized.

CUMAA directs the NCUA to develop separate risk-based net worth requirements (RBNWRs) for "complex" credit unions. As a result, credit unions holding long-term real estate loans, business loans, long-term investments, loans sold with recourse, and high allowances for loan losses may be subject to additional net worth requirements.

Credit unions classified as serving large numbers of low-income households are permitted to use secondary capital accounts to meet their net worth requirements. These accounts are structured so that their claims are subordinate to other creditors and the NCUSIF. These instruments are discussed further in Chapter 5.

4 This section draws extensively from James A. Wilcox, *Subordinated Debt for Credit Unions* (Madison, WI: Filene Research Institute, 2002), 11–16.

New credit unions are defined as those that have been in operation for less than 10 years and have less than $10 million (M) in assets. NCUA rules, which are discussed in Chapter 5, make some allowance for their challenges in ramping up to adequate capital levels.

Under CUMAA, credit unions that are less than adequately capitalized may be placed under net worth restoration plans to bring them into compliance with net worth requirements. The NCUA has discretionary power to temporarily classify special deposits as regulatory capital if it believes it will help the credit union eventually reach adequate net worth levels.

Differences in Bank and Credit Union Risk Profiles and Capital Requirements

The substantial differences between capital standards for banks and credit unions cannot be justified on the basis of comparative risk profiles. The less risky institutions (credit unions) are required to have higher capital levels than the more risky institutions (banks). As previously mentioned, CUMAA requires credit unions to maintain a 7% capital ratio to qualify as well capitalized, but bank regulators say banks are well capitalized if they have only a 5% ratio. Stated another way, credit unions need 40% more capital than banks do in order to be considered well capitalized. Economic theory suggests that credit unions take fewer risks than banks (Smith 1984). Because they take fewer risks, credit unions need not hold as much capital. Supporting theoretical predictions that credit unions have lower risk profiles than banks are many studies, including Kane and Hendershott (1996), Smith and Woodbury (2001), Wilcox (2005b), and Wilcox (2007). The economics and finance literature has long recognized that the combination of the

> Credit unions classified as serving large numbers of low-income households are permitted to use secondary capital accounts to meet their net worth requirements.

WHAT IS NET WORTH?

As mentioned previously, federal law dictates that net worth for most credit unions can be created only through retaining earnings. According to the NCUA, net worth includes "undivided earnings, regular reserves, appropriation for non-conforming assets (state chartered credit unions only), and other reserves (appropriations of undivided earnings)" (2005, 12).

profit-maximizing orientation of banks and insured deposit funding encourages more risk taking (Kane 1989).

The U.S. Department of the Treasury defends higher required capital standards for credit unions. It claims that Congress determined that a higher capital ratio was appropriate because credit unions cannot quickly issue capital stock to raise their net worth should a financial need arise. Instead, credit unions must rely on retained earnings to build net worth, which necessarily takes time (U.S. Department of the Treasury 2001, 11).

Lifting the ban on alternative capital would lessen credit unions' dependence on retained earnings, thus eliminating the need for higher capital standards.

The U.S. Government Accountability Office (GAO) also argues for maintaining higher capital standards for credit unions because of their dependence on retained earnings as a source of capital. At the same time, the GAO does not support proposals to allow credit unions access to alternative capital (U.S. Government Accountability Office 2004, 36). This is ironic, since lifting the ban on alternative capital would lessen credit unions' dependence on retained earnings, thus eliminating the need for higher capital standards.

The U.S. Department of the Treasury says Congress established a capital level two percentage points higher for credit unions than banks—a level recommended by Treasury—because 1% of a credit union's assets is dedicated to the NCUSIF and another 1% is dedicated to its corporate credit union (U.S. Department of the Treasury 2001, 11).

The NCUA disagrees with Treasury's position on capital levels. It states that according to generally accepted accounting principles (GAAP), which Congress mandated credit unions follow, the NCUSIF deposit is considered an asset on credit unions' financial statements. The NCUA points out that the NCUSIF deposit is not related to a credit union's net worth from either an accounting or a financial risk standpoint. The GAO, however, argues that NCUSIF deposits are not liquid and therefore are not immediately accessible for credit unions to use as a capital buffer (U.S. Government Accountability Office 2004, 36). The GAO's argument is difficult to reconcile with conventional notions of capital, which do not require immediate liquidity. Priority of claims, not liquidity, is the essence of capital.

The NCUA also says that because not all credit unions have investments in corporate credit unions, using a one-size-fits-all approach to trigger PCA supervisory actions based on the corporate-investment assumption is inherently unfair (U.S. Government Accountability Office 2004, 36).

CHAPTER 3
Consequences of Prohibiting Alternative Capital in Credit Unions

There are many negative consequences to prohibiting alternative capital by credit unions. Credit unions could face slower recovery from financial setbacks, limitations on growth, and overcapitalization.

There are at least six negative consequences of prohibiting the acquisition of alternative capital by U.S. credit unions:

- Slower recovery from financial setbacks.
- Fewer new credit unions.
- Limitations on growth and the addition of new services.
- Difficulty in achieving economies of scale.
- Conversion of credit unions to bank and thrift charters.
- Overcapitalization.

Slower Recovery from Financial Setbacks

All financial institutions face some threat of potential losses. Sometimes losses are caused by uncontrollable external factors such as natural disasters, workforce reductions at sponsor companies, and sudden declines in local economies. Losses may also be caused by internal failures in loan underwriting or operating systems.

Losses, of course, reduce capital. Infusions of alternative capital can prevent institutional failure, shorten recovery periods, and protect deposit insurance funds. Without alternative capital options, credit unions that have suffered capital losses must restore their capital levels through the relatively slow process of retaining earnings. While rebuilding capital to adequate levels, their capital levels are substandard, and they often pose greater risk to the deposit insurer than well-capitalized credit unions do.

Infusions of alternative capital can also accelerate the recovery process and lessen harm to credit union members and their communities. Without alternative capital, credit unions often find it necessary to shrink assets to achieve satisfactory capital-to-asset ratios. In addition, capital-deficient credit unions may need to boost earnings during recovery periods by reducing deposit rates, raising loan rates,

increasing fees, and cutting operating expenses, all of which have negative member and community consequences.

Fewer New Credit Unions

Because net worth requirements can be satisfied only through retained earnings, launching and growing a credit union in the United States is extraordinarily difficult. In many ways, people contemplating starting a credit union face a classic conundrum: It takes capital to build assets, but it takes assets to build capital.

New banks are required to start with a minimum amount of capital, which they obtain by issuing stock and using other capital instruments. In contrast, credit unions cannot issue stock, and they begin their existence with no capital. As mentioned previously, the NCUA does have special rules for new credit unions. New credit unions have up to five years to accumulate a net worth of 2% of assets, and they must be adequately capitalized at a minimum of 6% in 10 years. This is a higher hurdle than it may appear. A new credit union typically needs to grow assets quickly to reach an economically viable size. Rapid asset growth, in turn, necessitates extraordinarily high capital growth rates if the credit union is to meet the 2% and 6% standards.

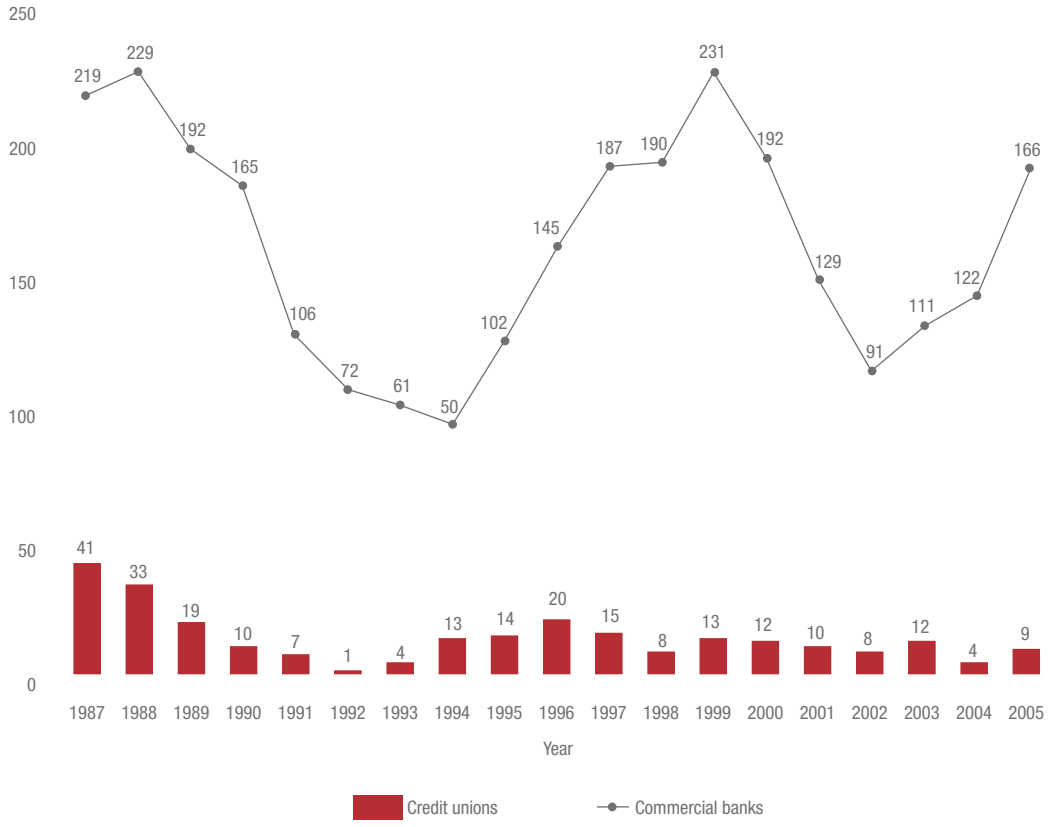
From 1996 to 2005, new commercial bank charters averaged 156 per year, while new credit union charters averaged 11 per year—a 14:1 ratio.

Limitations on credit union capital creation options are barriers to entry. Given the differences in capital accessibility, it's not surprising to find that very few new credit unions are formed compared with banks. From 1996 to 2005, new commercial bank charters averaged 156 per year, while new credit union charters averaged 11 per year—a 14:1 ratio. Furthermore, the majority of credit unions launched during that period were low-income community development credit unions, a special category of credit unions empowered to use subordinated debt and other instruments to satisfy capital requirements.

Limitations on Growth and the Addition of New Services

The growth rate of a U.S. credit union is constrained by its ability to add capital through retained earnings. If assets grow at a rate faster than capital grows internally, the net worth ratio declines. In practice, regulators view declining capital ratios as adverse trends, even if a credit union's net ratio remains over the 6% defined by statute as adequate capitalization. Federal and state regulators often issue oral and written warnings to credit unions with falling capital levels, and they may take strong steps to ensure capital levels they perceive as appropriate are achieved.

Figure 2: New Charters



Sources: FDIC, NCUA, and CUNA.

Without access to external sources of capital, a credit union may be unable to meet the growing and evolving needs of its existing membership. It may not be able to expand to fill the needs of the low-income and underserved segments of its community. Capital constraints make it more difficult to add new members and respond to promising marketing opportunities.

Difficulty in Achieving Economies of Scale

An inability to add capital adversely affects a credit union's expense ratio by making it more difficult to achieve economies associated with a larger scale of operations. Several studies reveal an inverse relationship between a credit union's size and its operating expense ratio. For example, Wilcox's research for the Federal Reserve Bank of San Francisco finds that "credit unions of all sizes likely will face growing pressures to improve efficiency by increasing the scale of their operations, either by internal growth or by acquiring other credit unions" (Wilcox 2005a, 3).

Doyle and Kelly (2005) found that a credit union's expense ratio is best predicted using a model that incorporates five factors: (1) deposits per member, (2) credit union size, (3) loan-to-assets ratio, (4) average loan size, and (5) real estate loans. A lack of capital-raising capabilities adversely affects performance in each of these areas: Without capital, a credit union cannot expand its deposits per member and total asset base (1 and 2), increase the number and size of loans (3 and 4), and assist its members in obtaining loans or purchasing homes (5).

Conversion of Credit Unions to Bank and Thrift Charters

Credit unions needing more capital than they can raise through retained earnings may be tempted to convert to bank or thrift charters. If there were widespread conversions of credit unions to other charters, consumer choice would be reduced. Large numbers of consumers would no longer have nonprofit, member-owned, one-member–one-vote options in the financial services marketplace.

Capital constraints make it more difficult to add new members and respond to promising marketing opportunities.

Most analysts believe that meaningful consumer choice is good for consumers in most product and service categories, including financial services. The evidence is also clear that credit unions typically behave differently than banks in the marketplace, largely because of their unique ownership and governance structure.

Thirty-one credit unions have converted to thrift and bank charters since 1998, and six are in the process of converting as of May 15, 2007 ("Conversion Update" 2007). Many more are actively considering a charter change.

The capital advantages of thrift and bank charters are frequently cited reasons for many charter conversions. As noted previously, credit unions must maintain a 7% capital ratio to be well capitalized, while banks need only maintain a 5% ratio. Also, banks and thrifts can raise large amounts of capital more quickly through the issuance of stock and alternative capital instruments.

Given the capital-formation limitations of credit unions, it is not surprising that organizations specializing in converting credit union charters regularly tout the capital advantages of thrifts and banks to potential clients. The following is an example of a conversion specialist's core marketing message regarding capital:

> *In addition to retaining earnings, banks have many ways to increase regulatory capital empowering them to expand services to members and the community, including loans, branches, employment and deposit products. For example, Pacific Trust Federal, a former credit*

union, raised almost $65 million in regulatory capital in a member approved IPO. The additional capital allows it to grow from $300 million to $2 billion, thus seeding a significant boost to the local community. As a credit union—even if other impediments were lifted—growing to this level of service would require over a decade of retained earnings. ("Solid Benefits & CU Handcuffs" 2003, 2)

Overcapitalization

From a macroeconomic perspective, excess capital is largely nonproductive and not in the public interest. From the perspective of credit union members, the process of building excess capital often deprives them of such benefits as lower loan rates, higher rates on savings, and more or higher-quality services in the short and medium term, and possibly in the long run as well.

Prohibiting capital creation alternatives creates incentives for credit unions to seek higher capital levels than they would if alternative capital options were open to them. The following example illustrates the rational component of the tendency to overcapitalize when options are restricted:

- Two identical credit unions in similar economic environments need about the same amount of base capital to operate in a safe and sound manner. In addition, both need safety capital to cover unplanned events. Some of these unplanned events—like unanticipated membership and asset growth spurts—are likely to be beneficial in the long run. Some events—like unanticipated operating losses—will be detrimental. Whether these events are positive or negative, they will reduce the credit unions' capital ratios, possibly below legally required levels.
- If both credit unions operate rationally, have the same knowledge, and have equal access to capital, they will carry identical amounts of safety capital. However, if one credit union can obtain new capital only through retained earnings and the other has many faster alternatives, the former should carry more safety capital than the latter.

Given the capital-formation limitations of credit unions, it is not surprising that organizations specializing in converting credit union charters regularly tout the capital advantages of thrifts and banks to potential clients.

Growing retained earnings is a relatively slow method of replenishing basic and safety capital compared to alternatives used by banks and cooperatives. Carrying more safety capital in credit unions is rational, but only up to a certain level of capital.

Behavioral Distortions

Rational behavior, however, does not fully explain the overcapitalization tendencies of credit unions lacking access to alternative

capital sources. Credit unions often seek an additional amount of excess capital.

The fields of behavioral economics and organizational psychology provide insights into this tendency to increase safety capital beyond rationally defensible levels. Researchers find that decision makers place more importance on potential losses than they do on gains: "In general, we tend to feel worse about a loss than we feel good about a win. The disutility of a loss is stronger than the utility of a win" (Holt and Charness 2005, 23). Consequently, we expect U.S. credit unions to hold even more safety capital than is necessary after adjusting for their highly constrained capital access options.

In addition, incentive systems shape behavior. Credit union regulators, boards of directors, and executives operate in systems with penalties and rewards that discourage risk taking (including, in many instances, carefully calculated, rational risk taking) and contribute to the overcapitalization problem:

- *Regulators.* Their internal accountability and reward systems incent them to emphasize risk minimization over fully rational risk management. Examiners are not promoted or otherwise rewarded if credit unions under their watch fail or flounder. Therefore, it is not surprising that they tend to be overly vigilant, even in the best of times. They predictably encourage credit union actions that result in higher capital levels than are rationally necessary.
- *Boards of directors.* These unpaid volunteers are not rewarded for taking chances, and they risk criticism from members, regulators, and the community if the credit union falters. Consequently, they favor organizational stability over maximizing member benefits, a pursuit involving greater organizational risk. Excess capital is perceived as stability enhancing. Economic theory's prediction that credit unions take on less risk than banks is primarily based on their governance structures, the primary difference between credit unions and banks (Jackson 2003, 105).
- *Managers.* Their job tenure depends on their ability to satisfy risk-averse regulators and boards. Because unemployment is undesirable, most managers enjoy the reassurance that comes from the high capital levels coveted by regulators and boards. Also, excess capital makes managers' jobs easier. They do not pay explicit interest on retained earnings to members. Overall, there are few job-related penalties to offset managers' incentives to hold excess capital.

In addition, incentive systems shape behavior. Credit union regulators, boards of directors, and executives operate in systems with penalties and rewards that discourage risk taking (including, in many instances, carefully calculated, rational risk taking) and contribute to the overcapitalization problem.

In summary, the lack of capital formation options makes risk-averse regulators, boards, and managers even more cautious and more willing to pursue irrationally high capital levels. Furthermore, behavioral incentives preclude fully rational behavior. The general result is excessively high capital levels in credit unions.

The Dangers of Overcapitalization

Excessively high capital levels reduce the value of credit union membership, and accumulation of excessive capital by the credit union is worth less to a member than higher savings rates, lower loan rates, and low service fees.

Excess capital also threatens the overall stability of the U.S. credit union system. It is a key factor underlying recent credit union conversions to bank and thrift charters. In addition, credit unions with excessive capital are vulnerable to friendly and hostile takeovers by banks and other credit unions. A recent example involves Wings Financial Federal Credit Union and Continental Federal Credit Union.

In 2007, Wings Financial FCU attempted to merge with Continental FCU. Both credit unions primarily serve airline workers. After Continental's management and board of directors turned down the merger idea, Wings appealed directly to Continental members, showing them the benefits of a merger, offering them a special $200 bonus dividend if the proposed merger took place, and asking them to persuade the Continental board to approve the merger. Continental's leadership strongly resisted and labeled the Wings proposal a hostile takeover attempt.

Overcapitalization makes Continental FCU a tempting merger target. At the end of 2006, it had a net worth ratio of 16.8%, compared to 11% at its peers. But Continental is "loaded with even more capital than the net worth ratio suggests: its loans are only 33% of total assets, and its net worth to loans ratio is an incredible 50%. That's like painting a takeover bulls eye on your chest," argues Hoel (Rubenstein 2007, 9). The excess capital at Continental FCU made it economically possible for Wings to promise to pay each former Continental member a special $200 bonus dividend.[5]

Are U.S. Credit Unions Overcapitalized?

Given alternative capital restrictions and behavioral theory and research, one would expect U.S. credit union capital to exceed necessary levels. Credit union data support this expectation. At the

5 After the bonus offer was made, the NCUA ruled that such a promise was illegal. Wings later abandoned its efforts to persuade Continental members to lobby for the merger.

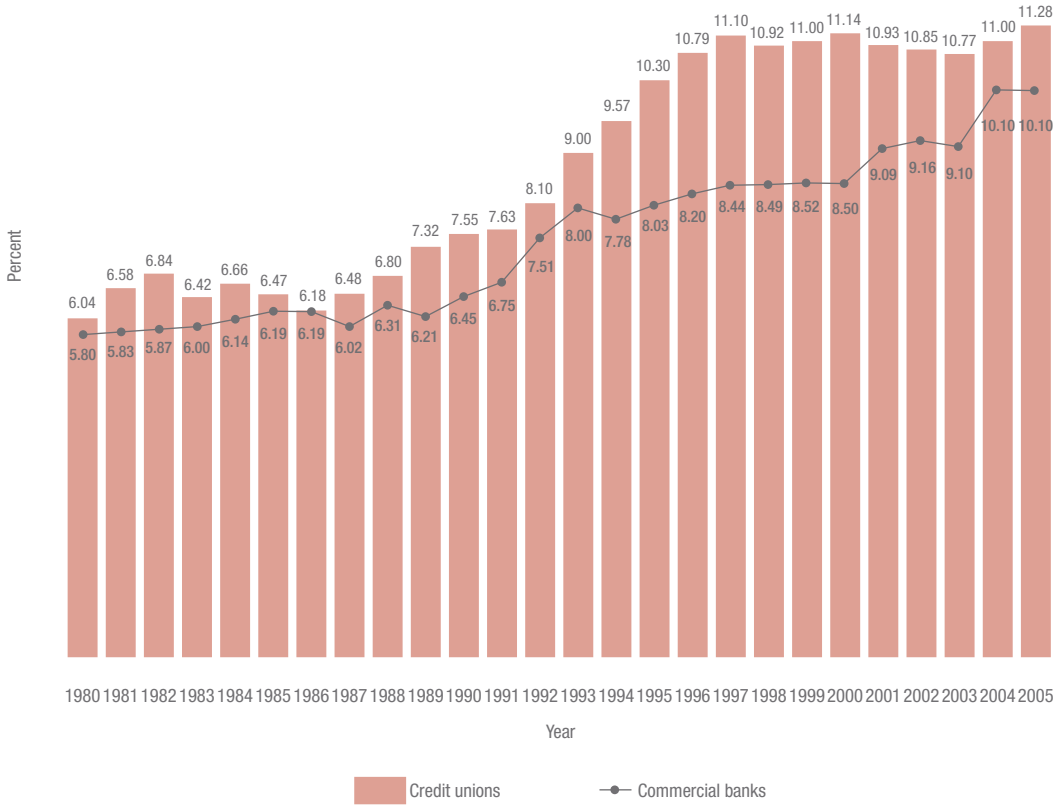
end of 2006, the net capital ratio excluding loan loss allowances was 11.4% of total assets, though federal law states that a credit union is adequately capitalized at 6%. Loan delinquencies were a mere 0.68% of total loans. Over the past 15 years, annual loan loss provisions have been only 0.28%–0.42% of total assets. Even at the highest annual charge-off rate of 0.42%, it would take the average credit union more than 27 years to deplete capital if it did not have positive earnings or change size. Capital per credit union member was a more-than-adequate $950 at the end of 2006.

Data support the general expectation of higher credit union capital levels, even though banks have riskier asset portfolios and higher delinquency rates than credit unions.

Because banks can increase capital in a wide variety of ways, one would expect banks to have lower capital ratios than credit unions. As shown in Figure 3, data support the general expectation of higher credit union capital levels, even though banks have riskier asset portfolios and higher delinquency rates than credit unions.

In a forthcoming Filene report, Jackson examines credit, interest-rate, liquidity, and operational risks and the industry composition

Figure 3: Equity Capital as a Percentage of Total Assets



Sources: FDIC, NCUA, and CUNA E&S.

characteristics of credit unions and banks in 1990 and 2006. His analysis leads to the same conclusion reached by Sollenberger (2005): The credit union industry not only has much more capital in 2006 than it did in 1990, but it also has a lower risk profile. Jackson concludes that U.S. credit unions are overcapitalized. He recommends major adjustments in capital requirements:

The evidence strongly suggests that credit unions are indeed overcapitalized.

> *To achieve comparability, the PCA leverage requirement for credit unions should be lower than the leverage requirement for banks and thrifts. Based on the articles by Kane and Hendershott (1996) and Smith and Woodbury (2001), which compare credit union risk taking to that of banks and thrifts, I would recommend a net worth ratio for Well-Capitalized credit unions of three-quarters to four-fifths of that for banks and thrifts.* (Jackson, forthcoming)

In summary, the evidence strongly suggests that credit unions are indeed overcapitalized. Allowing access to additional capital sources would lower credit union capital to more appropriate levels.

TAXATION

U.S. credit unions are exempt from taxation of earnings. Because credit unions are prone to building excess capital given their alternative capital limitations, they are likely to limit or postpone member dividends, which are taxed at the individual member level and rate. As a result, U.S. and state treasuries receive smaller and delayed tax revenues from individual credit union members.

On the other hand, exempting credit union earnings from taxation mitigates to some degree the negative results of denying credit unions access to alternative capital. When a troubled credit union encounters financial difficulty, it is able to replenish capital more quickly because future earnings destined for retention are not diminished by taxation. Taxing credit union earnings would likely exacerbate problems created by prohibiting alternative capital formation methods.

CHAPTER 4
Capital Options in Other Financial Institutions and Cooperatives

Cooperatives and financial institutions in the United States and abroad enjoy a wide array of options for obtaining alternative capital. There are several options that may be of interest to policymakers and others considering altering U.S. policies that prohibit credit unions from accessing alternative capital.

U.S. Banks[6]

The widespread problems in the U.S. banking and thrift industries during the 1980s and early 1990s prompted many reforms in required capitalization levels. Understandably, Congress and regulators wish to prevent future financial institution catastrophes that would adversely affect the U.S. economic system, federal deposit insurance agencies, and local communities.

Today's bank capital requirements are not only complex, but constantly evolving, and they are likely to be influenced by future Basel Accord standards and other capital standards established by international bank regulators. The following material describes the general pattern of U.S. bank capital requirements.

A bank must meet three minimum capital requirements to avoid remedial actions, including possible closure, by regulators. Unlike with U.S. credit unions, several asset classes are assigned weights of less than 100% when calculating capital ratios. The three capital requirements are:

- A leverage ratio based on the total assets of the bank.
- A core capital (Tier 1) ratio.
- A total capital (Tier 1 plus Tier 2) ratio.

The Leverage Ratio

To qualify as adequately capitalized, a bank must hold a minimum of 3% of Tier 1 capital relative to (unweighted) total assets. Tier 1 capital includes common equity plus retained earnings, noncumulative perpetual preferred stock, limited amounts of cumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.

6 This section draws heavily from James A. Wilcox, *Subordinated Debt for Credit Unions* (Madison, WI: Filene Research Institute, 2002).

The Core Capital (Tier 1) Ratio

To qualify as adequately capitalized, a bank must hold a minimum of 4% of Tier 1 capital relative to risk-weighted assets. As of this writing, the asset risk-weighting system assigns each class of assets a weight of 0%, 20%, 50%, or 100%. Cash and securities issued by governments of most developed countries have a weight of 0%. Claims on banks and securities issued by the U.S. government or agencies that do not have the backing of the full faith and credit of the United States receive a weight of 20%. Some mortgage loans, certain asset-backed securities, and most derivative transactions receive a weight of 50%. Typically, commercial loans receive the standard weight of 100%. Some off-balance-sheet items may be included in the four risk categories.

The Total Capital (Tier 1 plus Tier 2) Ratio

To qualify as adequately capitalized, a bank must hold a minimum of 8% of total capital (Tier 1 and Tier 2) relative to risk-weighted assets. Tier 2 capital (also known as supplementary capital) may consist of intermediate-term and/or cumulative preferred stock, allowances for loan losses, hybrid instruments that combine equity and debt characteristics, unrealized gains on equity securities, and subordinated debt. The total amount of these components that may be counted toward Tier 2 capital cannot exceed the amount of Tier 1 capital. Additional amounts of the components of Tier 2 capital may be held, but they do not count toward the capital requirement. There are other restrictions on the maximum qualifying amounts of the different components.

Subordinated debt is of special interest in this report because it shows substantial promise as a potential alternative capital vehicle for credit unions.

Subordinated Debt as Tier 2 Capital

Subordinated debt is of special interest in this report because it shows substantial promise as a potential alternative capital vehicle for credit unions. Subordinated debt is subordinated to the claims of depositors and other creditors. It helps insulate deposit insurance funds from losses. If a bank is unable to pay its depositors, the deposit insurance agency does not pay depositors until claims of subordinated debt holders have been exhausted.

In the case of U.S. banks, the amount of subordinated debt plus intermediate-term preferred stock that qualifies as Tier 2 capital cannot exceed 50% of Tier 1 capital. In order to qualify as Tier 2 capital at banks, subordinated debt must:

- Not contain provisions that permit holders to accelerate the payment of principal prior to maturity.

- Not be credit-sensitive (i.e., not make increased interest payments in near-default situations).
- Have an original weighted average maturity of no less than five years. Issues with a remaining maturity of between four and five years are weighted to be counted as capital at 80% of face value, between three and four years at 40%, and between one and two years at 20%. Issues with remaining maturity of less than one year receive a 0% weight.

Cooperatives in the United States and Abroad[7]

Non-credit-union cooperatives have discovered many ways to expand their capital bases without abandoning their essential cooperative nature. Like credit unions, they need to gather sufficient capital to serve their members well, extend services to new members, expand their menu of services, and achieve economies of scale. Also, they wish to operate in a safe and sound manner. Unlike their U.S. credit union siblings, they are not compelled to rely solely on retained earnings as a source of capital.

Non-credit-union cooperatives have discovered many ways to expand their capital bases without abandoning their essential cooperative nature.

U.S. Cooperatives

Founded mainly in the early part of the twentieth century in the United States, traditional cooperatives, often in the agricultural arena, were financed with modest stock purchases by their initial members. The purchase of a single voting share was typical. New members in traditional cooperatives made minimal contributions to capital as a condition of membership.

Traditional stock cooperatives can expand capital by retaining earnings from three sources:

- *Nonmember business.* These earnings are retained as permanent capital and are called unallocated equity capital, reserves, or surplus on cooperative balance sheets.
- *Member business (allocated).* Earnings from member business may be retained by the cooperatives and equity shares distributed to members. Legally for federal income tax purposes, at least 20% of earnings must be paid in cash, while the other 80% may be retained by the cooperative for working capital. These retained earnings are allocated to a specific member who has rights to

7 The material in this section draws heavily from Michael L. Cook and Fabio R. Chaddad, *Capital Acquisition in North American and European Cooperatives* (Madison, WI: Filene Research Institute, 2006).

their proceeds when the shares are redeemed at the discretion of the board of directors. Redemption practices vary greatly among cooperatives.

- *Member business (unallocated).* Earnings from member business may become part of permanent capital and not allocated or redeemable by individual members.

Nonstock cooperatives typically accumulate capital through a system of per-unit retained funds called "retains." Under these systems, a cooperative (e.g., an agricultural producer cooperative) retains a specified portion of the value of each member's deliveries with the expectation that the retained funds will be returned to the member within a few years. Thus, the retains become a form of capital.

"New generation cooperatives" represent a major change in how cooperatives create capital. These cooperatives conduct capital drives that often generate sufficient equity capital to justify bank loans for multimillion-dollar facilities. The typical goal is to pay high cash returns to members on their investments in the cooperative. Capital investments in new generation cooperatives are redeemed rapidly compared to those in traditional stock cooperatives.

The equity shares in stock cooperatives and the per-unit retains (often described as debt) in nonstock organizations are rightfully considered to be capital. First, they are usually subordinated to all other financial obligations of the cooperative. Second, they are relatively permanent and cannot flee quickly in times of economic crisis. Though they may be partially redeemable, bylaws typically allow redemptions only with the approval of the board of directors.

Democratic control continues even though capital structures have evolved. Most cooperatives still operate on a one-member–one-vote basis.

Democratic control continues even though capital structures have evolved. Most cooperatives still operate on a one-member–one-vote basis. Proportional voting arrangements, however, are used by some. Proportional voting schemes are increasingly tied to patronage or weighted combinations of patronage and equity holdings. Cooperatives using proportional voting typically limit the percentage of total votes that can be cast by a single member.

European Cooperatives

As in the United States, the European cooperative is a local cooperative founded on principles of member ownership, member benefit, and member control. Important sources of funding, historically, were nonallocated patronage equity and bank debt, often obtained from cooperative lending institutions.

Over time, it proved advantageous for local European cooperatives to form regional associations and ultimately national federations, generally along a single crop or service line. These larger organizations permitted gains from economies of scale, and they provided greater access to capital. The frequent result is an interlinked, multitiered (local, district, regional, and national) cooperative structure.

An important capital development tool has been the introduction of PLCs, limited liability companies that are wholly or partially owned by individual cooperatives or groups of cooperatives. PLCs become operational arms of the cooperatives. While the PLC may be called a cooperative by the general public, it is really an investor-based entity owned by a cooperative.

The ownership by cooperative associations of these investor-owned holding companies creates a range of possibilities for equity investment in cooperatively owned operations. Because a PLC is an investor-owned entity, nonmembers can invest in and receive investment returns from the PLC without violating the cooperative character of the association.

Some differences exist between the other financial instruments used by European cooperatives and those used in the United States. However, most European instruments would be readily recognized by accounting specialists from U.S. cooperatives.

Trends in Capital Formation Tools for Cooperatives

In general, cooperatives in developed nations are expanding their options for capital formation. Sometimes these expansions require new laws, and sometimes they do not. Following are some examples of recent trends in capital formation.

- *Strategic alliances.* In this nontraditional financial model, the cooperative has the option of forming strategic alliances with partners to acquire permanent equity capital from nonmember sources. For example, Dairy Farmers of America (DFA), the largest U.S. dairy cooperative, established a holding company structure to govern strategic alliances in downstream businesses in the milk supply chain. As much as 30% of the milk volume handled by DFA is marked and processed by strategic alliances.
- *Trust companies*. In this model, the cooperative establishes a separate nonoperating trust company solely for the purpose of acquiring risk capital from nonmember sources, particularly institutional investors. Diamond of California is a marketing cooperative owned by 2,000 walnut growers. It recently acquired capital through its Diamond Walnut Capital Trust. The actual financing instrument is a 12-year, fixed-dividend, nonvoting preferred stock of the trust.

- *Preferred stock.* CoBank, a Denver-based cooperative bank, completed the private placement of $300M of its cumulative preferred stock. The preferred stock does not carry voting rights in the cooperative. It is a fixed-dividend, nonredeemable instrument.
- *Nonvoting common stock and investor participation shares.* In many countries, including Canada, France, the United Kingdom, and Australia, nonmembers are allowed to invest in cooperative associations and receive nonfixed dividends. However, these models do not grant nonmembers voting rights.

Non-U.S. Credit Unions and Cooperative Credit Associations

Credit cooperatives, including credit unions, in most developed nations enjoy a broader array of capital formation options than U.S. credit unions do. Typically they must satisfy Basel Accord requirements. Many operate subsidiaries that bring capital to support the cooperative's mission and do so without impacting the cooperative's capital position stated on its balance sheet.

Basel Accords

The Basel I and Basel II agreements, reached in 1988 and 2004 by central bankers, establish minimum capital standards for financial institutions. They have been endorsed and fully or partially implemented by G10 countries and more than 100 other nations.

The Basel agreements generally define Tier 1 and Tier 2 capital, and they recommend appropriate amounts of capital in relation to risk-weighted assets. Because of variations in the legal frameworks across nations, each country's regulator has some discretion regarding how differing financial instruments may count in the capital adequacy calculation.

Credit cooperatives, including credit unions, in most developed nations enjoy a broader array of capital formation options than U.S. credit unions do.

Most central banks and regulators follow the Bank of International Settlements' guidelines in setting asset risk weights. Assets like cash and coins usually have zero risk weightings, unsecured loans have a risk weight of 100%, and most types of secured loans are weighted somewhere in between.

Tier 1 capital is the core measure of a financial institution's financial strength because it is relatively permanent and reliable. Examples of Tier 1 capital are common stock, retained earnings, and preferred stock that is irredeemable and noncumulative.

Tier 2 capital is less permanent and reliable than Tier 1 capital. However, it cannot be withdrawn quickly if the financial institution

experiences financial setbacks or fails. Furthermore, it is subordinated to almost all other claims on assets and earnings. Subordinated debt is a popular form of Tier 2 capital. It is debt that is not redeemable over a usually lengthy set term, and it can be repaid only after other claims, including those of ordinary depositors, are paid in full. Other examples of Tier 2 capital are hybrid financial instruments combining some characteristics of both shareholder equity and debt.

Membership Restrictions and Capital Opportunities[8]

Unlike U.S. credit unions, most credit cooperatives are not constrained by requirements limiting membership to people who share a common bond of geography, employment, or association. European credit cooperatives, for example, are permitted to attract capital and deposits from members outside their target market, thus enabling wealthy urban dwellers to sometimes invest funds in less affluent rural areas.

Retention of Earnings

As in U.S credit unions, retention of earnings is the primary way to build capital. Foreign credit cooperatives obtain capital initially from individuals who deposit money in a share account and become cooperative members. Because funds on deposit can be withdrawn upon the demand of the member, cooperatives seek to build capital through retained earnings, which are more permanent.

Trust-Preferred Securities

Trust-preferred securities have become a popular method of securing additional capital from nonmembers. Rabobank, a large credit cooperative based in the Netherlands, has issued Class B Preferred stock since 1999 to trusts that then issue trust-preferred securities to outside, nonmember investors. Outside investors obtain a fixed rate of return indexed to government bond rates. They are not allowed to convert their securities into regular Rabobank shares. Only the trust—which Rabobank controls—can convert its preferred stock shares into regular shares. Rabobank sells trust-preferred securities to U.S. investors through a trust it formed in Delaware.

PLCs

PLCs, which were described previously in the context of all cooperatives, have become another key method for building capital at credit cooperatives. PLCs are limited liability companies that are wholly or partially owned by individual cooperatives or groups of cooperatives. PLCs owned by credit cooperatives may provide services such

8 The remaining parts of this section draw heavily from Cook and Chaddad (2006).

Australian credit unions provide a recent example of how credit cooperatives can attract Tier 1 and Tier 2 capital from investors. In 2006, 21 Australian credit unions collaborated to obtain a total of A$100 million (US$85M) in capital from outside investors. Half the total raised was for Tier 1 capital at 20 credit unions, and half was for Tier 2 capital at 21 credit unions. Funds obtained through this effort qualify as Tier 1 and Tier 2 capital under the guidelines of the Australian Prudential Regulation Authority.

By working together, marketing and overall funding costs were more favorable. CUNA Mutual, the leading credit union insurer in the United States with extensive Australian credit union business, and ABN-AMRO, a global financial conglomerate based in the Netherlands, played key roles in coordinating, structuring, and placing the offering.

The transaction involved creating two special-purpose vehicles: a Tier 1 trust and a Tier 2 special-purpose issuer (SPI). The Tier 1 instruments sold to investors are perpetual, noncumulative, and subordinate to almost all other claims including those of depositors, thereby satisfying key Tier 1 Basel requirements. The Tier 1 instruments have a floating dividend rate. Credit unions can call the instruments after 10 years. If they choose not to, there is a 100 basis point step-up in the rate paid to investors.

The Tier 2 instruments provide capital that is less permanent than the Tier 1 instruments. They are subordinated debt notes with a 10-year term and floating rates. They are not callable by the credit union for at least five years.

To facilitate placement of these Tier 2 subordinated debt instruments at favorable rates, the SPI issued notes in three classes (tranches) that were rated by Standard and Poors: $33.5M (AAA) senior notes, $10M (BBB) mezzanine notes, and $6.5M (BB) junior notes.

Each credit union received Tier 1 and Tier 2 capital as an individual entity. Each is separately responsible for meeting its obligations to the investors. There is no cross default among the Tier 1 instruments issued by the different credit unions. Similarly, there is no cross default among the Tier 2 instruments issued by different credit unions.[9]

9 Based on information obtained from Standard and Poors (2006), ABN-AMRO, the CUNA Mutual Group, and Australian credit unions.

as aggregated investing and clearing services to the cooperative, members, or outside customers. Sometimes they invest in activities beyond the traditional scope of the credit cooperative. For example, Rabobank has expanded internationally to acquire organizations in the United States and other countries well beyond the direct interests of their owners in Dutch communities.

The Irish Model

The so-called Irish model refers to a general method developed by Irish credit cooperatives to expand their capital bases. In this approach, assets of the cooperative are transferred to an investor-owned firm in exchange for the cooperative receiving all stock, a minority portion of which is then sold on the Dublin and London stock exchanges to outside investors. Through this model, the cooperative retains control over the assets by holding the majority of stock outstanding, but it can access capital from outside, nonmember investors.

Credit cooperatives outside the United States also issue subordinated debt to obtain capital from external investors without diluting the share ownership rights of members.

Subordinated Debt

Credit cooperatives outside the United States also issue subordinated debt to obtain capital from external investors without diluting the share ownership rights of members. Subordinated debt programs vary widely. In some cases, investors in these debt instruments receive returns based on a percentage of the cooperative's earnings. In other cases, investors receive a defined return. In both general cases the claims of the securities holders are subordinated to virtually all claims by other creditors and depositors.

CHAPTER 5
Special Situations Where Alternative Capital Is Permitted for U.S. Credit Unions

Though laws and regulations do not permit most U.S. credit unions to use alternative capital, there are three significant exceptions: low-income credit unions, some state-chartered credit unions with private deposit insurance, and corporate credit unions that were created to serve other credit unions.

Low-Income Credit Unions

As Congress has repeatedly recognized, access to capital is essential but exceptionally difficult for credit unions that primarily serve low-income households. These credit unions tend to have low deposit and loan balances, relatively high operating costs, and above-average vulnerability to loan losses (National Federation of Community Development Credit Unions 2007, 5).

In 1970, Congress granted federally insured low-income credit unions (LICUs) the right to accept nonmember uninsured deposits. Later regulations began to permit these deposits to be considered a form of capital.

CUMAA explicitly allows secondary (alternative) capital to be included in net worth calculations at federally insured LICUs. It states that for LICUs, net worth "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 [National Credit Union Share Insurance] Fund" (National Credit Union Administration 2007, Section 1790d).

A secondary capital account at a LICU is deeply subordinated debt. It fully counts as net worth when its maturity exceeds five years.

A secondary capital account at a LICU is deeply subordinated debt. It fully counts as net worth when its maturity exceeds five years. Each year after its maturity drops below five years, 20% becomes general debt for the credit union and is no longer counted as net worth capital.

Usage and Defaults

In March 2007, only 47 of the 1,061 credit unions officially designated as LICUs had outstanding secondary capital. Total secondary capital reported was $27.6M, with secondary capital at individual credit unions ranging from $5,000 to $9M.

Since 1997, the National Federation of Community Development Credit Unions (NFCDCU) has helped its member credit unions obtain $9M of secondary capital, largely from philanthropic organizations. Secondary capital losses occurred in seven credit unions, with total losses approximating $1M. Six of the defaulting credit unions are no longer in business. Given the challenges of serving low-income areas, it is not surprising that secondary capital losses are high (NFCDCU 2007).

The NFCDCU finds secondary capital especially valuable for fast-growing, high-performing LICUs that otherwise could not grow without running afoul of regulators and prompting PCA. Secondary capital has also proved important for other LICUs, including some long-established minority church-based credit unions that had below-par capital ratios (NFCDCU 2007, 6).

Alternative Capital Caps

The NCUA generally restricts nonmember deposits in a LICU to a maximum of 20% of total deposits. This so-called 20% rule is controversial. The NFCDCU argues that the restrictions are no longer necessary and burdensome:

> *As in the past, LICUs are obliged to prepare business plans and request special permission to accept non-member deposits in excess of their (20%) quota, even if these funds are low-cost or interest free. Some examiners continue to pressure LICUs to return to investors deposits that they already hold, and that could be used to earn income for the credit unions. In any case, those credit unions that are most successful in raising philanthropic, CRA, or other social investments must still incur unnecessary paperwork burdens, petitioning NCUA regional directors for relief.* (NFCDCU 2007, 6)

State-Chartered Credit Unions

Federal law restricting capital exclusively to net worth applies to all federally insured, natural person credit unions. All federal credit unions must have federal insurance on deposits. In addition, most state-chartered credit unions are federally insured. If they wish, states may permit their non-federally-insured credit unions to use alternative capital. Some states now count membership shares as capital.

Though the number of state-chartered credit unions is large, the number of privately insured credit unions is small. As of March 2007, 3,146 state-chartered credit unions make up 37% of the total credit union population of 8,592 credit unions, and they account for $326 billion (B), or 43%, of the movement's $751B in assets.

Twenty-nine states, according to the Credit Union National Association (CUNA), make some provision allowing private deposit insurance. In addition, regulator approval is often required, and

some regulators have been reluctant to approve private insurance. Sometimes the credit union's membership must also vote to approve private deposit insurance.

CUNA reports that as of March 2007, there are 174 non-federally-insured credit unions with total assets just under $17B. Relative to the size of the U.S. credit union movement, the number of non-LICUs eligible for secondary capital is small.

If the number of state-chartered credit unions eligible for alternative capital is to increase, federal laws prohibiting alternative capital at federally insured credit unions need to be repealed or modified.

State Calls for Alternative Capital Reform

The National Association of State Credit Union Supervisors (NASCUS) is the professional association for state credit union supervisors (regulators). Its past chairman, Jerrie J. Lattimore, who also serves as North Carolina's chief credit union regulator, testified before Congress on March 27, 2003, about the value of permitting alternative capital. The following is from her testimony:

> *As a regulator, it makes no business sense to deny credit unions the use of other forms of capital that improve their safety and soundness. We should take every financially feasible step to strengthen the capital base of this nation's credit union system.*

Lattimore pointed out that denying access to alternative capital (1) constricts credit union membership service and growth, and (2) encourages and sometimes forces credit unions to convert to non-credit-union charters (Lattimore 2003).

A NASCUS task force reexamined the alternative capital issue and various models for structuring capital in 2005. Its conclusion was unequivocal:

Figure 4: Privately Insured Credit Unions, March 2007

State	Number of privately insured credit unions	Assets (in millions)
Alabama	3	$599
California	18	$7,113
Idaho	19	$160
Illinois	35	$3,086
Indiana	17	$1,340
Maryland	3	$98
Nevada	8	$2,479
New Hampshire	1	<$1
Ohio	70	$1,878
Total	**174**	**$16,753**

Source: CUNA.

NASCUS firmly believes that credit unions should have access to alternative capital and that it can be done in a safe and sound manner. (Alternative Capital for Credit Unions 2005, 10)

It continues to be a priority for NASCUS to study and advocate capital reform for credit unions with the ultimate goal of expanding the definition of net worth for credit unions to include alternative capital.

EXAMPLES: TWO START-UP, STATE-CHARTERED CREDIT UNIONS

ABBOTT LABORATORIES EMPLOYEES CREDIT UNION

Abbott Laboratories Employees Credit Union (ALEC), a state-chartered, privately insured credit union based in Illinois, was founded in 1989 with the assistance of the Abbott Laboratories company. The firm wanted its employees to have the "fringe benefit" of credit union access. Abbott provided initial capitalization by making an uninsured "redeemable capital contribution" of $6M. The agreement between Abbott and ALEC did not specify a maturity date, though Abbott expected to be repaid eventually. The contribution was interest-free to the credit union. It was fully at risk and subordinate to claims of depositors and other creditors.

State of Illinois regulators approved the capital contribution plan and chartered the credit union. American Share Insurance (ASI), a nongovernment credit union deposit insurer, also approved the redeemable capital contribution arrangement. Both treated Abbott's contribution as capital, though all parties were aware that the contribution was not intended to be permanent.

ALEC is thriving. Three years after its founding, it elected to repay the $6M in full. Today ALEC has $430M in assets and more than $300M in loans. It regularly receives a CAMEL 1 rating by regulators.

A SECOND CREDIT UNION

About the same time ALEC was founded, another credit union was launched, but its fate was far different. A sponsoring employer provided uninsured capital and also covered the credit union's operating expenses during the start-up period. The credit union suffered large loan losses and failed after a couple of years. The sponsor lost its $250,000 capital contribution plus the operating expenses.

The credit union may have failed, but alternative capital properly played its loss-mitigating role, as it must when credit unions and other financial institutions experience financial difficulties. Claims on alternative capital were subordinate to claims by depositors, the deposit insurer, and other claimants. The deposit insurer was protected from substantial loss by the credit union's alternative capital. (The name of the credit union has been withheld at the request of the interviewees.)

Exemption from Federal Income Taxes

Not surprisingly, credit unions wish to maintain their exemption from federal income taxes. The U.S. Code exempts "credit unions without capital stock organized and operated for mutual purposes and without profit." Federally chartered credit unions are exempt from income taxation under U.S. Internal Revenue Code, Section 501 because they are federal instrumentalities. State-chartered credit unions are exempted from federal income tax under the Code's Section 501(c)(14)(A).

If state law permits, a state-chartered credit union that is not federally insured can have capital options that are not afforded to federally chartered or insured credit unions while continuing to be exempt from federal income taxes. It may issue subordinated debt or similar instruments if the instrument is not deemed to be "capital stock" and the credit union continues to operate "for mutual purposes without profit."

Following the Code's requirement, the Internal Revenue Service (IRS) often uses a three-pronged test for determining tax exemption. Under one of those prongs, a credit union is barred from issuing capital stock if it wishes to be tax exempt. However, neither the

EXAMPLE: ALTERNATIVE CAPITAL AT AN ESTABLISHED CREDIT UNION

STATE EMPLOYEES' CREDIT UNION OF NORTH CAROLINA

State Employees' Credit Union of North Carolina, a state-chartered, federally insured credit union, entered into an "equity shares investment agreement" on June 30, 2001, and received a $1M infusion of alternative capital. The investment is not insured by the NCUSIF or any other deposit-insuring entity. The agreement calls for the credit union to pay to the investor a premium rate equivalent to Federal Home Loan Bank of Atlanta's quarterly dividend. In exchange, the investor agrees that it cannot redeem its shares without at least five years' notice, and then only if the redemption would not cause State Employees' Credit Union to fail to comply with government capital standards.

Holders of the equity shares have no voting rights, and the dividend is not guaranteed. Furthermore, the shares are subordinate to all other claims, including those of the NCUSIF.

The credit union received an outside audit opinion stating that the equity shares satisfy GAAP capital standards. The state regulator is comfortable with the arrangement and with the conclusion that the shares qualify as capital. However, CUMAA does not allow the equity shares to satisfy minimum capital standards applicable to federally insured credit unions.

Internal Revenue Code nor IRS regulations define capital stock for the purpose of judging a credit union's tax exemption status. The relatively few published court opinions on the subject suggest that the absence of some features make an instrument less like stock and more like debt. Typical stock features are voting rights, distributions at the discretion of the issuer, appreciation in the instrument's value in accordance with the issuer's profitability, and participation in the residual interests of the issuer at the time of liquidation. Debt instruments, in contrast, usually include repayment of the face amount at a certain maturity date and a fixed or variable return not tied to issuer profitability (*Alternative Capital for Credit Unions* 2005, 4).

In the case of State Employees' Credit Union of North Carolina, discussed in the sidebar, the IRS issued a private letter ruling that the equity shares did not disqualify the credit union from its federal income tax exemption (*Alternative Capital for Credit Unions* 2005, 7).

Corporate Credit Unions

Corporate credit unions are special credit unions that serve other credit unions rather than natural persons. Corporate credit unions enjoy a broader definition of capital and are specifically exempted from the Federal Credit Union Act's requirement that only retained earnings can count as net worth. As stated in NCUA's Rule 704.2, capital is the "sum of a corporate credit union's retained earnings, paid-in capital, and membership capital." A minimum capital ratio of 4% is required.

Rule 704.3 further clarifies paid-in capital and membership capital:

- *Member paid-in capital.* Paid-in capital accounts are callable at the option of the corporate credit union and only if the corporate credit union meets its minimum level of required capital and other requirements. In the event of liquidation of the credit

DO THESE ALTERNATIVE CAPITAL PROGRAMS WORK?

Alternative capital has enabled low-income, state-chartered with private insurance, and corporate credit unions to serve more members, expand their operations, and offer additional services. It has increased their capacity to weather economic fluctuations. It has enhanced their capital bases, which protect depositors and deposit insurance funds from losses. All available literature reviewed and personal interviews conducted during the course of this research indicate that alternative capital, when permitted in credit unions, has performed its primary economic functions well.

union, paid-in capital is payable only after satisfaction of all liabilities and claims including uninsured deposits and obligations to NCUSIF and membership capital holders.

- *Membership capital.* These funds may be in the form of a term certificate or an adjusted balance account. These funds can be withdrawn by depositors with a minimum notice of three years. In the event of liquidation of the corporate credit union, membership capital is payable only after satisfaction of all liabilities and claims excluding paid-in capital. (NCUA 2006)

Member paid-in capital and membership capital are forms of alternative capital in the context of this report. These instruments help ensure a healthy corporate credit union system and constitute 63% of total corporate credit union capital.

Figure 5: Sources of Capital—Corporate Credit Unions, March 31, 2007

	Capital	Percent of Total
Retained earnings	$2,876,517,851	37.02
Paid-in capital	$803,504,005	10.34
Membership capital	$4,089,790,461	52.64
Total capital	$7,769,810,317	100.00

Source: The Association of Corporate Credit Unions.

CHAPTER 6
Proposals for Expanding Alternative Capital Options

There are many potential sources of alternative capital for credit unions, including credit union members, outside investors, and other credit unions willing to loan their excess capital.

Uninsured Deposits by Credit Union Members

Like other cooperatives, credit unions could obtain alternative capital directly from their members in the form of uninsured deposits, sometimes called member investment shares. The deposits would have long maturities so the funds could not flee quickly if the credit union encountered financial difficulties. Being uninsured, these deposits would, of course, be subordinate to the claims of depositors in insured accounts and those of the deposit insurer. To compensate members for accepting greater risk, the credit union would offer higher interest rates on these uninsured accounts.

Member Knowledge and Interest in Uninsured Certificates of Deposit[10]

Credit union members vary greatly in their knowledge about deposit insurance. Lee and Kelly found that 77% of the credit union members participating in their study had heard about federal deposit insurance, but only a little more than half of those who had heard of it claimed they completely understood it. Among all respondents, 23% said they didn't understand it, 36% indicated limited knowledge, and 41% said they completely understood it.

To determine consumer interest in acquiring uninsured depository products, Lee and Kelly provided four groups of credit union members with information about a new uninsured certificate of deposit (CD). Each group received basic information about the product, and three of the four groups received additional information:

- Group A received only basic product information.
- Group B received basic product information plus the interest rate translated into dollar amounts.

10 This section reports findings from Jinkook Lee and William A. Kelly Jr., *Uninsured Accounts: An Assessment of Member Interest* (Madison, WI: Filene Research Institute, 2003).

- Group C received basic product information plus NCUA information about the rate of credit union failures causing a loss to the federal deposit insurance fund (0.0017%).
- Group D received basic information plus the additional information given to both Group B and Group C.

The addition of information boosted member interest in uninsured CDs. Members in Group A received only basic product information, and they were the least interested. Group D members received the most information, and they were the most interested.

Interest in uninsured deposit products soared when members were given a choice of what proportion of funds they would allocate to insured and uninsured accounts. The likelihood of purchasing an uninsured CD and the proportion of $10,000 that members wanted to place in this certificate were highest in Group D, whose members received the most information.

Members participating in the Lee-Kelly study who were generally more knowledgeable about savings and investment products were more likely to respond favorably to the uninsured CD than members who had less knowledge. Also, these members who were generally knowledgeable about savings and investment products were more likely to view the uninsured CD more favorably when they were given information about credit union failure rates and when the interest rate was translated into dollars.

The Design of Uninsured CDs[11]

Building on knowledge obtained in the Lee-Kelly study of member interest in uninsured accounts, Kwon and Lee conducted three

Figure 6: Indicators of Member Interest in an Uninsured CD

	Information given member	Percent likely to use product	Of $10,000 total deposit, percent depositing $1,000 or more in uninsured account	Of $10,000 total deposit, median uninsured deposit
Group A	Basic product info (BPI) only	13	63	$1,000
Group B	BPI plus interest rate translated into dollar amounts	40	87	$5,000
Group C	BPI plus info on credit union failure rates	47	93	$5,000
Group D	BPI plus info given to Groups B and C	87	93	$7,500

11 This section reports findings from Kyoung-Nan Kwon and Jinkook Lee, *Secondary Capital Products: An Assessment of Member Interest* (Madison, WI: Filene Research Institute, 2006).

experiments involving a total of 1,750 credit union members in five credit unions across the nation. The experiments examined possible CD design features, including:

- Bundling an uninsured product with an insured product. For example, a bundled CD could be 50% insured and 50% uninsured.
- Interest rates.
- Maturity length. Products tested were 5- to 10-year CDs with no early withdrawals.

The experiments also measured the characteristics of members most likely to purchase a fully or partially insured long-term CD.

A small but significant minority (12%–18%) of participants in each experiment indicated they were very likely (6 and 7 on a 7-point scale) to acquire a five-year CD without early withdrawal privileges. The member's willingness to acquire a long-term CD was greater when one or more of the following occurred:

- Federal deposit insurance was offered to cover all of the CD's value.
- The annual percentage was given for a bundled product rather than its separate components.
- The annual percentage was larger rather than smaller.
- Comparative product information was provided.
- The member's objective financial knowledge was low.
- The member's acceptable financial risk level was average or somewhat above average.
- The member's financial assets were less than $50,000, not including retirement savings.

Conclusions and Commentary: Uninsured CDs

A significant minority of credit union members would welcome the opportunity to purchase long-term uninsured CDs that would qualify as alternative and secondary credit union capital. Given the low failure rate of credit unions and an interest-rate premium to compensate for the lack of deposit insurance, uninsured credit union CDs would make excellent additions to many members' investment portfolios.

Most uninsured credit union CDs would likely be relatively safe investments, similar to quality uninsured corporate bonds. They would have an added benefit: The credit union issuing the CDs is regularly examined by government regulators, who take remedial actions when they observe financial weakness.

However, there are perils. Some uninsured CDs would be riskier investments than others. Furthermore, research shows that many

credit union members likely to be interested in purchasing uninsured CDs are unsophisticated investors who do not understand the role of deposit insurance and its overall value. Some have limited wealth and would be seriously harmed if the credit union defaulted. They might become confused about the major differences between insured and uninsured CDs. There is always a danger that some would misunderstand the risk–reward tradeoff, even if it was fully explained to them.

Most uninsured credit union CDs would likely be relatively safe investments, similar to quality uninsured corporate bonds.

In summary, uninsured CDs could benefit many of the members who purchase them, as well as the credit union membership as a whole. But if credit unions are allowed to issue uninsured CDs, special care should be taken to protect unsophisticated members who are not fully aware of the risk involved.

Membership Capital Shares

Many credit unions require their members to maintain a modest minimum amount in their accounts, typically less than $50. The minimum deposit amounts can be withdrawn only upon termination of membership. These deposits tend to be highly stable, and the annual interest cost is usually low or sometimes zero, similar to retained earnings. Furthermore, credit unions often have a legal right to refuse to pay out these minimum amounts if net worth levels are inadequate (Alternative Capital Task Force 2001, 1).

If these minimum deposits were uninsured and counted as net worth, a credit union would be able to increase capital by raising the minimum deposit amount required. Also, members might be encouraged to voluntarily make higher minimum deposits in exchange for special privileges or special rates on services.

Member Paid-in Capital

The member paid-in capital approach is based on the corporate credit union model, where qualifying member paid-in capital is perpetual and uninsured. Corporate credit union paid-in capital without stated maturity is considered equity for GAAP purposes and primary capital by the NCUA, and it satisfies several important capital requirements for corporate credit unions. The same approach could be used by natural person credit unions if federal law permitted (Alternative Capital Task Force 2001, 4).

Member paid-in capital appears to be an excellent net worth component for calculating capital adequacy.

Member paid-in capital appears to be an excellent net worth component for calculating capital adequacy. It is stable because it is

perpetual and cannot flee in times of financial crisis. In corporate credit unions, member paid-in capital is callable only at the option of the credit union and only if the credit union meets its minimum level of required capital and other requirements. Though payments to capital holders may be higher than payments on insured accounts, dividends are noncumulative. In the event of the liquidation of the credit union, paid-in capital is payable only after the satisfaction of all liabilities and claims, including uninsured deposits and obligations to the NCUSIF and holders of membership capital shares.

Subordinated Debt Issued to Investors[12]

James A. Wilcox, a prominent authority on risk management at financial institutions, proposes that credit unions be permitted to issue subordinated debt to outside investors in much the same way that community banks are allowed to do so. Banks often issue long-term subordinated bonds with maturities of 10 to 20 years. The claims of the bond holders are explicitly subordinate to those of depositors, deposit insurers, and other claimants in the event of default.

If credit unions were permitted to issue similar instruments and regulators were able to count them as a form of capital, the pathway to alternative capital for credit unions would be open.

Bank regulators, as noted in Chapter 4, count subordinated debt as Tier 2 capital. If credit unions were permitted to issue similar instruments and regulators were able to count them as a form of capital, the pathway to alternative capital for credit unions would be open.

Subordinated Debt Instruments

Wilcox points out that credit union alternative capital instruments could be structured in a variety of ways, and legislation and regulations would influence their ultimate structures. However, subordinated debt in credit unions would probably be structured along the lines seen in banking.

The key features of credit union subordinated debt would likely be:

- Long maturities.
- A higher coupon rate than those paid on regular credit union shares and CDs.
- Junior standing in liquidations.
- No voting rights for bond holders.

12 The following sections draw heavily from two Filene Research Institute reports by James A. Wilcox—*Subordinated Debt for Credit Unions* (2002) and *Capital Instruments for Credit Unions: Precedents, Issuance and Implementation* (2003).

- No direct influence over management.
- The right of management to forgo payment in specified situations.

Benefits to Regulators

Subordinated debt enhances regulatory efforts because it:

- *Imposes direct market discipline on credit union decision making.* Credit unions wishing to issue subordinated debt would know that the cost of obtaining subordinated debt is directly related to investor perceptions of the risk of default. The prospect of higher funding costs provides an incentive for credit unions to refrain from taking excessive risk.
- *Imposes indirect market discipline.* Regulators are likely to interpret a rise in the interest rate an individual credit union must pay for subordinated debt as a signal of potentially increased risk at that credit union. After observing an upward rate change, the regulator may wish to investigate the credit union's financial condition further and possibly take corrective action.
- *Enhances transparency and disclosure.* Subordinated debt investors require full and complete information about the credit union's operations and financial condition.
- *Increases the size of the financial cushion provided to the deposit insurer.* Because holders of subordinated debt are compensated only after the deposit insurer has been compensated, the addition of subordinated debt provides the deposit insurance fund with additional safety.
- *Reduces the need for supervisory forbearance.* While PCA schedules empower and eventually require supervisors to place ever-greater restrictions on credit unions with deteriorating net worth ratios, there is likely to be some forbearance by supervisors. Subordinated debt may keep credit unions from dropping below PCA and potential forbearance trigger points. Also, holders of subordinated debt may encourage supervisors to take action earlier to prevent troubled institutions from accumulating larger losses and further depleting the value of outstanding subordinated debt.

Subordinated Debt and Net Worth Requirements

If Congress were to permit credit unions to use alternative capital, a key question is how alternative capital would satisfy net worth requirements. The interchangeability of subordinated debt and retained earnings could be set anywhere between zero and 100%. Zero percent represents the status quo, where subordinated debt is not counted at all as net worth. At the other end of the spectrum is an exchange rate of 100%, where a dollar of subordinated debt would count as a full dollar of net worth. An interchangeability ratio

of 50% means that each dollar of subordinated debt would count as 50 cents of net worth.

A subordinated debt instrument's length of time until maturity also raises net worth questions. The alternative capital counting scheme currently used by LICUs might be applied. As discussed in Chapter 5, subordinated debt in LICUs fully counts as net worth when its maturity exceeds five years. Each year after its maturity drops below five years, 20% becomes general debt for the credit union and is no longer counted as net worth capital.

Enhancing the Marketability of Subordinated Debt and Other Alternative Capital Securities

Financial institutions wishing to issue small amounts of securities have traditionally been thwarted by high interest and issuance costs. However, since 2000, pooling mechanisms have provided access to capital markets to large numbers of financial institutions that had previously been considered too small to issue securities into public markets. These pools are extremely flexible. They can simultaneously include trust-preferred securities and subordinated debt and fixed- and floating-rate issues. They are sufficiently elastic to include several types of securities that might be issued by credit unions.

Wilcox's interviews with investment bankers revealed their interest in further expanding pooling mechanisms to include capital securities issued by credit unions.

Wilcox points out the possibility of developing pooling mechanisms that purchase only securities issued by credit unions. However, if the volume of capital securities issued by credit unions did not justify the development of separate credit-union-only pools, credit unions would probably be welcomed into mixed pools along with banks and thrifts.

Wilcox's interviews with investment bankers revealed their interest in further expanding pooling mechanisms to include capital securities issued by credit unions. His 2003 report analyzes bank capital securities and pooling mechanisms and also possible comparable credit union securities and mechanisms providing alternative capital.

A Credit Union Distribution System for Alternative Capital Emerges[13]

Many potential marketers, distributors, and purchasers of credit union subordinated debt and other alternative capital instruments are service and product supply organizations specializing in meeting

13 The next two sections are based on Thomas J. Merfeld, "New Strategies to Obtain Secondary Capital," in *Managing Credit Union Capital: Subordinated Debt, Uninsured Deposits, and Other Secondary Sources* (Madison, WI: Filene Research Institute, 2004) and also on documents supplied by the CUNA Mutual Group.

the needs of credit unions. Some are owned by credit unions and their members.

In 2003 the CUNA Mutual Group, a diversified, mutually owned financial organization founded in 1935 to serve credit unions, introduced Capital Notes, a secondary capital product. Phase 1 of CUNA Mutual's program is designed for LICUs. Phase 2 will adapt the program to all credit unions if Congress acts to permit alternative capital in mainstream credit unions.

Under the program, CUNA Mutual purchases an alternative capital instrument that is a nonvoting, medium-to-long-term (more than five-year) subordinated note. The investment contract explicitly states that the note holder will not become involved in the governance of the credit union. The note may have a fixed or floating rate, at the option of the credit union. There is a risk adjustment on the issuance yield, charging more for a credit union that has lower capital or more risky assets. This yield adjustment applies market discipline to the program. The note is prepayable at the option of the credit union. In extraordinary circumstances a credit union can defer a coupon payment without triggering default. The initial plan is to limit secondary capital to a maximum of 25% of total capital (retained earnings plus secondary capital).

In phase 2, when the program would be made available to credit unions not designated by the NCUA as low-income, there might be more credit union demand for subordinated debt capital than CUNA Mutual could retain on its own balance sheet. If this occurred, CUNA Mutual would create trusts to fund its purchases of the subordinated notes. The trusts would sell rights to certain cash flows, or tranches, to be paid by the trusts. The trusts would work with a rating agency to define and rate bundles of cash flows as AAA, AA, A, and unrated. CUNA Mutual is confident that there would be sufficient investor demand for these bundles.

Alternative capital is not inexpensive. Investors demand a significant premium because of risk and length of time to maturity.

The Cost of Subordinated Debt

Alternative capital is not inexpensive. Investors demand a significant premium because of risk and length of time to maturity. Bank costs for floating-rate subordinated notes may be 250–300 basis points over LIBOR (London Interbank Offered Rate), and for fixed-rate notes, costs may be 275–325 basis points over 10-year treasury notes. However, credit unions generally have lower risk profiles than banks, so the issuance spreads might be lower. On the other hand, the liquidity premium might have to be somewhat higher for credit unions.

In a narrow sense, subordinated debt is too expensive to use for making individual loans to credit union members. The net interest spread is too small. But looking at individual loans is inappropriate. It overlooks the point that secondary capital allows the credit union to expand and is intended to support the credit union's overall business. Also, it is important to remember that alternative or secondary capital may be used for relatively short periods of time compared to primary capital. These are conceptual hurdles that both credit union CEOs and regulators need to overcome.

Other Capital Options

Leased Capital

Another proposal is to permit credit unions with excess capital to loan or lease that capital to credit unions in need of additional capital. The capital-borrowing credit union could pay a fee to the capital-providing credit union, or it might share the monetary benefits of greater growth. Under this proposal, a credit union faced with growth opportunities could accept increased deposits and make additional loans while using leased capital to cover the associated decrease in its net worth ratio. The capital-providing credit union would receive above-market rates, or its goal might be more philosophically motivated.

Nonmember Paid-in Capital

In the so-called nonmember paid-in capital approach, a limited liability company (LLC) is created. Initial LLC capital is contributed by a small group of credit union members who receive senior voting rights in the LLC. Most capital (e.g., 97%) is contributed by other investors who receive junior voting rights. The LLC then becomes a member of the credit union and purchases a special uninsured share certificate with most alternative capital features. The certificate is perpetual and callable only by the credit union. The certificate's interest rate is higher than rates paid on insured certificates. As a credit union member, the LLC has only one vote (*Alternative Capital for Credit Unions* 2005, 8–9).

Alternative Capital and Complex Credit Unions

The NCUA can immediately allow complex credit unions to use some alternative capital, with no need for legislative change to make this possible, according to Wilcox.

Complex credit unions are now subject to additional capital requirements associated with an RBNWR calculation. All federally insured credit unions can use only retained earnings to meet net worth requirements of 6% or 7% to be adequately or well capitalized. However, federal law does not explicitly mandate that incremental

capital required for additional credit union complexity be in the form of retained earnings. Therefore, the NCUA, if it wishes, could permit alternative capital to fulfill the need for additional RBNWR capital (Wilcox 2002).

Permitting alternative capital to satisfy incremental RBNWR requirements would provide the NCUA and the credit union movement a testing ground for subordinated debt procedures and instruments. Two regulatory issues that would need to be addressed are the interchangeability ratio of alternative capital and retained earnings, and how to count subordinated debt when the maturity date of the instrument is less than a trigger period of, say, five years.

CHAPTER 7
Public Policy, Managerial Implications, and Recommendations

Is it in the public interest to permit credit unions greater access to alternative capital sources? Alternative capital could be used to promote growth and stability among credit unions. Prohibiting alternative capital reduces competition and narrows consumer choice.

This chapter further addresses the three general questions posed at the beginning of this report:

- Is it in the public interest to permit U.S. credit unions greater access to alternative capital sources?
- Can credit unions use alternative capital to expand their capital bases in a way that will not dilute cooperative ownership, values, and governance structure?
- What alternative capital mechanisms would be most appropriate and feasible?

In addition, this chapter examines the question of when alternative capital reforms should be made.

Prohibiting Alternative Capital vs. Regulating It

Automobiles and alternative capital have much in common in the area of public policy: Automobiles generate a wide range of consumer benefits, but if driven improperly, they can be dangerous and destructive. If they wish to reduce or eliminate the dangers of automobiles, policymakers have three choices:

- Ban automobiles (or prohibit automobile driving).
- Regulate automobiles (e.g., speed limits, equipment standards, and vigilant police enforcement).
- Educate drivers.

It's widely agreed that the first alternative—banning all autos or prohibiting driving—thwarts rather than advances the public interest. Most policymakers also believe that a partial ban—one arbitrarily prohibiting certain classifications of people (e.g., women and people less than six feet tall) from driving—is unfair, inappropriate, and discriminatory. Instead of implementing unreasonable bans on automo-

biles or driving, policymakers opt for some combination of the other two choices—regulation and education.

Like autos used by individuals, alternative capital used by financial institutions generates individual and societal benefits, but it can be used improperly. Should alternative capital be totally banned because of the potential for misuse? Should a partial ban be implemented so that one class of financial institutions (e.g., U.S. credit unions) is arbitrarily prohibited from using it? Can alternative capital be intelligently and effectively regulated instead? Is there a place for educating and coaching institutions that are contemplating its use?

Like autos used by individuals, alternative capital used by financial institutions generates individual and societal benefits, but it can be used improperly.

Benefits of Regulation and Education

Banks, thrifts, and cooperatives worldwide have found alternative capital highly useful in serving their patrons and their communities. Public policy makers and regulators have developed effective ways to regulate its use, and the present research has been unable to uncover compelling arguments for banning the use of alternative capital by financial institutions. There is no public outcry for its prohibition.

As discussed in previous chapters, the use of alternative capital in credit unions would generate many benefits for 90 million U.S. credit union members and other consumers of financial services. Alternative capital can:

- Make more credit union start-ups possible.
- Permit credit unions to grow and expand services.
- Lower credit unions' operating costs through economies of scale.
- Help credit unions recover from financial setbacks.
- Prevent unnecessary conversions to bank charters.
- Reduce the squandering of capital through overcapitalization.

All these outcomes are in the public interest because they expand consumer choice and enhance the efficiency of financial institutions and the financial system.

To be sure, alternative capital can be misused by any class of financial institution, including credit unions. The instruments can be poorly structured. Issuers can agree to imprudently high rates and attempt to attract too much alternative capital. But solving the potential problem by arbitrarily banning alternative capital is unnecessary and not in the public interest.

For inexplicable reasons, credit unions are the only U.S. depositories prohibited from using alternative capital. U.S. thrifts and banks can use a variety of alternative capital instruments. Government agencies, however, vigilantly monitor and regulate usage. These regulators educate and sometimes cajole those they regulate. For example, the Office of Thrift Supervision (OTS) became concerned about thrifts potentially misusing trust-preferred securities pools being used to raise alternative capital. Various OTS leaders and spokespeople said:

Credit unions are the only U.S. depositories prohibited from using alternative capital.

- "[Trust-preferred securities] are like any bank product—if it's used wisely, it's a good product."
- "We've seen instances where [thrifts] have been marketed to and told that there is a pooling vehicle in place and it's going to market, and so they've jumped on board without a real plan about how to use it."
- "We always talk to [thrifts] about use of proceeds and we generally try to work with them to make sure the amount they are using is right."
- "Part of our job here [at OTS] is to take the punch bowl away mid-party." (Mandaro 2002)

Regulatory and educational approaches to dealing with valuable alternative capital products appear far superior to outright prohibitions. Credit union regulators—just like their counterparts regulating banks and thrifts—are likely capable of crafting guidelines and procedures that will minimize potential misuse.

Serving the Public Interest

Optimal Public Policy

U.S. financial institutions operate under a patchwork of federal and state laws and regulations developed in response to financial crises, political pressures, and historical events. No single central agency is assigned the task of developing an overall system of regulation. Regulation evolves to serve numerous goals, many of which change over time and are in conflict with one another. In addition, the economy evolves, and consumer financial needs and preferences change. All of these dynamic factors contribute to the need to frequently reassess the appropriateness of laws and regulations affecting credit unions and other financial institutions.

Economist William E. Jackson III, reflecting the views of many experts, provides guidance for evaluating public policy issues relating to financial institutions:

It is important to remember the fundamental goal of regulation is to allow financial markets and institutions to work efficiently for the consumer, while maintaining the fundamental integrity, or safety and soundness, of the system. (Jackson 2003, 38)

The end goal of optimal regulatory policy is a marketplace with many choices for consumers, businesses, and other users of financial services. A financial system composed of homogeneous financial institutions is not ideal. Consumer choice, not restriction, should be the primary driver of change in the marketplace. (Jackson 2003, 43)

Jackson finds that deregulation of credit unions—through removing secondary capital prohibitions and other unneeded restrictions—would have a positive overall economic effect. He sees two basic economic benefits of removing barriers to greater efficiency and innovation: (1) credit unions will better serve their members, and (2) they will increase financial market competition, which will lead to a more efficient overall marketplace for nonmembers as well as members.

Jackson finds that deregulation of credit unions—through removing secondary capital prohibitions and other unneeded restrictions—would have a positive overall economic effect.

High Capital Requirements vs. Ability to Obtain Alternative Capital

With passage of CUMAA in 1998, credit unions became subject to PCA regulations somewhat similar to those of banks. However, the capital requirements for credit unions were set much higher than bank requirements, even though credit unions have lower risk profiles than banks, as shown in Chapter 2. One possible rationale for setting a higher capital requirement for credit unions might be their inability to quickly raise capital by issuing securities, as banks are able to do.

Allowing credit unions to obtain alternative capital from investors or members would remove the need to set excessively high capital requirements.

Allowing credit unions to obtain alternative capital from investors or members would remove the need to set excessively high capital requirements. Jackson finds that allowing alternative capital would be the more efficient approach because excessive capital requirements restrict the ability of the financial system to provide the optimal amount of credit to potential borrowers (2003, 80).

Prohibiting Alternative Capital—Other Undesirable Consequences

Previous chapters examined several undesirable consequences of prohibiting alternative capital options for credit unions. All have

adverse public policy implications. The largest set of undesirable consequences involves reducing competition and narrowing consumer choice:

- Fewer new credit unions.
- Unnecessarily low limits on membership and asset growth potential.
- Barriers to adding new services.
- Barriers to achieving economies of scale.
- Incentives for credit unions to convert to bank and thrift charters, thus limiting the variety of consumer choices in the marketplace.

The second set of consequences involves internal inefficiencies that ultimately affect communities and capital markets:

- Slower recoveries from economic setbacks.
- Overcapitalization of credit unions.

Public Policy Arguments for Prohibiting Alternative Capital

Though the negatives of prohibiting alternative capital are considerable, making public policy involves trade-offs. Do the advantages of prohibiting alternative capital outweigh the disadvantages?

It might be argued that credit unions are relatively unsophisticated and uninformed financial institutions that will irrationally acquire too much or too costly alternative capital. This would unduly raise chances for institutional failure. For this scenario to play out, it must be assumed that credit union regulators are also unsophisticated and would approve all credit union requests to issue alternative capital instruments.

Credit unions have demonstrated the ability to assimilate a wide variety of sophisticated new products and services into their operations.

The proposition that credit unions and their regulators are generally unsophisticated and uninformed is not supported by convincing evidence. Credit union failures have been rare under all national economic conditions. Credit unions have demonstrated the ability to assimilate a wide variety of sophisticated new products and services into their operations.

Another possible reason for prohibiting alternative capital might be a fear that credit unions would grow so quickly that they would destabilize the financial services system by reducing bank profits and putting banks out of business. This view grossly underestimates the ability of banks to attract and retain customers in a competitive marketplace. There is no credible evidence supporting this doomsday scenario.

Dilution of Credit Union Uniqueness

Credit unions take considerable pride in their uniqueness. They are member-owned financial cooperatives in which each member has a single vote regardless of the size of his or her account balance. Their boards of directors are composed of members (not investors) who are elected by their fellow members. In federal credit unions and almost all state-chartered credit unions, these board members serve without pay. Their mottos are "Not for profit, not for charity, but for service," "People helping people," and "Where people are more important than money."

As demonstrated by other cooperatives and foreign credit unions and financial cooperatives, alternative capital instruments can be crafted to avoid compromising unique ownership characteristics. None of the alternative capital proposals for U.S. credit unions that were discussed in the previous chapter alter the cooperative structure or dilute the one-vote-per-member principle. Boards of directors would continue to be elected by the membership, outsiders would continue to be banned from serving on the boards, and the volunteer leadership tradition would go on.

As demonstrated by other cooperatives and foreign credit unions and financial cooperatives, alternative capital instruments can be crafted to avoid compromising unique ownership characteristics.

However, some leaders within the credit union movement express concern about credit unions seeking alternative capital and bank-like capital structures. John M. Tippets, a highly respected credit union leader and CEO of American Airlines Federal Credit Union, is an outspoken critic of alternative capital. In correspondence with the author, Tippets stated the following:

> *What the authors of two Filene Research Institute reports on secondary capital seem to be missing are the philosophical and political benefits of not having access to bank-like capital structures. As cooperative financial institutions, our retained earnings source of capital gives members a critical sense of power and ownership. It is also a source of some strategy/growth/pricing discipline on management. And, that unique structure is certainly one of the justifications for a unique tax treatment.*

Tippets believes that funding capital through retention of earnings is one of several characteristics contributing to credit unions' uniqueness. Together, these characteristics (member ownership, not-for-profit economic model, etc.) make credit unions special. The erosion of any of these distinctions (which are advantages in his view) diminishes the whole credit union strategy. He believes the "cost" of alternative capital for credit unions is much higher than the interest rate paid to providers of that capital.

Jim Blaine, another highly respected credit union leader and CEO of State Employees' Credit Union of North Carolina, disagrees with Tippets. He sees alternative capital as central to the long-run viability of credit unions. He endorses the idea of obtaining alternative capital from members and sees it as a positive way to reward members for longer-term savings. Blaine also suggests that credit unions be permitted to count up to 2% alternative capital in PCA calculations, with the remainder being generated from retained earnings. He adds, "If we pursue secondary capital, credit unions must define it, limit it, and use it on credit union terms" ("Two Sides of Secondary Capital" 2002, 14).

Credit unions are highly democratic organizations, and it is not unusual to see differences of opinion on major issues like alternative capital.

Credit unions are highly democratic organizations, and it is not unusual to see differences of opinion on major issues like alternative capital. Evidence supporting claims that permitting alternative capital would diminish the uniqueness of credit unions is not strong in the eyes of this researcher. It is more plausible that access to alternative capital would strengthen credit unions, enabling them to better pursue their unique purpose and goals.

What Alternative Capital Mechanisms Are Most Appropriate?

Chapter 6 discussed several potential methods for obtaining alternative capital. They all require changes in federal law if they are to be implemented by non-LICU, federally insured credit unions. The primary potential sources of alternative capital are credit union members, outside investors, and other credit unions:

- Credit union members
  - Uninsured CDs
  - Membership capital shares
  - Member paid-in capital
- Outside investors
  - Subordinated debt
  - Nonmember paid-in capital
- Other credit unions
  - Leased capital
  - Subordinated debt

Obtaining alternative capital from members is closest to the credit union tradition of mutual assistance. Of the credit union member alternatives, uninsured CDs appear to have the strongest potential to raise large amounts of money. As previously discussed, research

indicates that a significant minority of members would consider purchasing them. On the negative side of the issue, many members who show interest in uninsured certificates are relatively unsophisticated and have modest savings. There is a danger that some members would become confused about which credit union offerings are insured and which are not.

The most attractive investor-based source of alternative capital is subordinated debt. Investors have considerable experience with these types of products, and pooling mechanisms are available to lower the interest rate and the cost of issuance. Also, one movement-related organization has already taken steps to purchase and distribute alternative capital instruments issued by credit unions. Subordinated debt types of alternative capital bring market discipline to credit union activities. On the negative side, subordinated debt is relatively expensive.

Though subordinated debt issued to investors and uninsured member deposits show the greatest promise, the alternatives previously discussed should not be discarded.

Though subordinated debt issued to investors and uninsured member deposits show the greatest promise, the alternatives previously discussed should not be discarded. U.S. credit unions are a heterogeneous lot, and a limited menu of alternatives is not ideal.

Lack of Credit Union Consensus on Proposals

The U.S. credit union movement generally supports calls for alternative capital for credit unions. It has not rallied around a specific proposal, and there is no consensus on the best source for alternative capital. Instead, the industry has endorsed general guidelines.

CUNA's formal policy statement is as follows:

> *CUNA supports the authority of credit unions to build additional capital either from members or nonmembers in a way that does not dilute the cooperative ownership and governance structure of credit unions. This additional capital should be subordinated to credit unions' share insurance funds so that credit unions have the financial base to offer member services and adjust to fluctuating economic conditions.* (CUNA 2005)

The National Association of Federal Credit Unions board endorses seven principles for evaluating alternative capital models and instruments:

- Preserve the not-for-profit, mutual, member-owned, and cooperative structure of credit unions and ensure that ownership interest (including influence) remains with the members.

- 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.
- Provide for a degree of permanence such that a sudden outflow of capital will not occur.
- Allow for a feasible means to augment capital.
- Provide a solution with market viability.
- Ensure that any proposed solution applies for PCA purposes (to include risk-based capital as appropriate) or changes the definition of net worth to include other equity capital balances.
- Ensure that any proposed solution qualifies as equity capital balances under GAAP and qualifies as an amendment redefining net worth.

The Current Need for Alternative Capital

On average, U.S. credit unions are well capitalized, and their balance sheets are strong. Capital is greater than 11% and charge-offs and delinquencies are low. More than 98% of all credit unions have net worth exceeding 7%, thereby meeting the CUMAA standard for being well capitalized.

The GAO Study on Alternative Capital

The U.S. Government Accountability Office, in its report *Credit Unions: Available Information Indicates No Compelling Need for Secondary Capital* (2004), states that credit unions are well capitalized. It says that the credit union industry's interest in making changes to the current capital requirements for credit unions appears to be driven by three primary concerns: (1) restricting the definition of net worth solely to retained earnings could trigger PCA actions due to conditions beyond credit unions' control, (2) PCA in its present form acts

Figure 7: Financial Strength—U.S. Credit Unions, End of 2006

		Asset size			
	All credit unions	Less than $5M	$5M–$20M	$20M–$100M	More than $100M
Net worth/assets	11.5	17.2	15.0	12.8	11.1
Credit unions with net worth exceeding 7% of assets	98.5	97.3	98.9	99.1	99.0
Delinquencies/ loans	0.68	2.78	1.49	1.02	0.58
Net chargeoffs/ average loans	0.47	0.77	0.55	0.49	0.46

Source: CUNA.

as a restraint on credit union growth, and (3) PCA trip wires for corrective action are too high given the conservative risk profile of most credit unions.

The GAO:

- Did not find evidence that the inflow of member share deposits resulted in widespread net worth problems for federally insured credit unions since PCA had been put in place.
- Found that credit unions grew faster than banks during the three years after PCA was put in place.
- Defended the high PCA trip wires established by Congress.
- Found that the credit union industry was not unified in its calls for reform and that proposals were not specific enough for assessment.
- Said that the potential use of a risk-based capital system for all credit unions appears less controversial than alternative capital.

One major reason for their interest in converting to a thrift or bank charter is the lack of capital-building options they have as credit unions.

A major omission in the GAO report is meaningful discussion of why credit unions should be subjected to competitive inequality as compared to banks in the area of alternative capital. Similarities and differences between banks and credit unions are not seriously explored. The report advocates economic discrimination without providing reasons.

The Fallacy of the Mean and the Case for Moving Forward Now

Averages are measures of central tendency, and they do not reveal the characteristics and needs of those who are not average. Credit unions are far from homogeneous. In fact, given their diversity, the term "average credit union" is usually misleading.

While an average credit union does not need or want alternative capital today, there are some that do. Those unaverage credit unions may face extraordinary growth opportunities, see how they can expand their product lines, wish to achieve economies of scale, or need to recover from economic setbacks.

Also, some credit unions are now contemplating abandonment of their credit union charters to become banks. One major reason for their interest in converting to a thrift or bank charter is the lack of capital-building options they have as credit unions. A significant subset of those contemplating charter changes would prefer to remain credit unions. Lifting alternative capital prohibitions now would allow them to abandon their plans to switch charters.

If it is in the public's and credit union movement's long-term interest to allow credit unions to use alternative capital, steps to remove alternative capital prohibitions should be taken as soon as possible, even if few credit unions will use it in the short term. The few innovators will provide learning experiences for other credit unions and their regulators. Investor markets can be developed slowly and intelligently. Later, if credit union demand for alternative capital soars, the insights gained from a slower-paced introductory period will prove useful.

The Case for Deregulation

Over the past 27 years, Congress has relaxed or eliminated many of the regulations imposed on depository institutions. These actions are responses to the impact of significant technological competitive and other market changes encountered by those institutions. Former Federal Reserve Board Chairman Alan Greenspan recognized the positive effect deregulation offers consumers when he said that deregulation provides financial services at lower prices, increased access, and higher-quality services. These benefits accompany the increased competition associated with permitting depository institutions to expand their activities (Greenspan 1993).

Former Federal Reserve Board Chairman Alan Greenspan recognized the positive effect deregulation offers consumers when he said that deregulation provides financial services at lower prices, increased access, and higher-quality services.

The process of deregulation produced positive results. It intensified competition among depository institutions, inducing them to expand product offerings, increase efficiency to align prices with production costs, and improve service to consumers.

Credit unions benefited far less from deregulation than commercial banks and thrifts. While the same factors that supported the deregulation of commercial banks and thrifts also support the deregulation of credit unions, credit union powers have gone largely unchanged over the past 20 years (Jackson 2003).

Lifting laws and regulations prohibiting the use of alternative capital by credit unions would be a big step forward in the deregulatory process. The benefits are substantial. Two other capital reforms also deserve review with an eye toward revision: lowering the capital levels required to meet PCA standards, and introducing risk-weighted capital standards.

Conclusions

Eight general research findings emerged during the course of this study:

- It is in the public interest to permit credit unions greater access to alternative capital sources.
- Federal and state laws and regulations should be amended to permit credit unions to obtain alternative capital.
- Credit unions can expand their capital bases using alternative capital in ways that will not dilute their cooperative ownership, values, and governance structure.
- Several different mechanisms for raising alternative capital are appropriate and feasible. Some of the most promising involve obtaining alternative capital from outside investors, and others involve acquiring special long-term deposits from credit union members.
- A broad menu of alternative capital options would best serve credit unions, their members, and the general public. There is no single method that is best for all credit unions seeking alternative capital.
- It would be appropriate for credit union regulators to review and approve a credit union's alternative capital plan and mechanisms prior to its issuance of alternative capital instruments.
- Though many credit unions may not wish to seek alternative capital now, having the power to do so would benefit them by allowing them to conduct their business with the confidence that, if necessary, they could build capital in a variety of ways beyond the slow retained-earnings approach.
- Steps should be taken promptly to repeal or reform statutes and regulations that prohibit credit unions from obtaining alternative capital. No compelling reasons to delay were uncovered during the course of this research.

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