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ALTERNATIVE CAPITAL FOR CREDIT UNIONS

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1.0 EXECUTIVE SUMMARY

All credit unions with the exception of low-income credit unions and corporate credit unions rely solely on retained earnings for growth. Low-income credit unions are the only ones permitted to utilize alternative capital sources. Alternative capital provides financial stability and reduces default risk for corporate credit unions and the National Credit Union Share Insurance Fund (NCUSIF). Additionally, it allows credit unions to meet consumer demand for affordable savings and lending products when many people are locked out of traditional financial institutions. Finally, alternative capital promotes credit union lending and growth resulting in economic stimulus and job creation without the aid of unpopular government bailouts and expansion of government bureaucracy.

In preparing this White Paper, the consultants reviewed research papers and industry reports discussing alternative capital for financial institutions broadly and for credit unions in particular. They also spoke with credit union experts. Under the current regulatory framework, the low-income designation grants access to supplemental capital and provides an ready route to Community Development Financial Institution (CDFI) certification, which in turn provides access to government funded programs such as the Community Development Capital Initiative and other grants and sponsorships. There are competitively awarded funding programs through other government entities, corporations, trusts and foundations that do not qualify as alternative capital for PCA purposes, but they are external funding sources that help credit unions serve their members.

Alternative capital options analyzed by name are (1) Member Paid-In Capital; (2) Non Member Paid-In Capital and (3) Subordinated Debt. For Member Paid-In Capital, members contribute additional capital with a specified return rate, often tied to an external standard (e.g. LIBOR). With Non-Member Paid-In Capital, capital is raised outside of credit union membership via a Limited Liability Corporation (LLC). The LLC is treated as a partnership for federal income tax purposes. Subordinated Debt involves issuance of a hybrid investment instrument (equity-like debt) that combines both debt and equity features – holders have no voting rights, no put rights and no appreciation in value in accordance with issuer's profitability.

While providing a feasible means for raising additional capital for ALL credit unions, these alternatives preserve the cooperative philosophy of credit unions, and the safety / soundness of their system. Options are primarily limited to low-income designated credit unions, except for rare cases.

2.0 Problem Statement

Alternative capital is non-standard forms of capital, i.e. outside core tier 1 capital, retained earnings and donations, including hybrid securities combining features of both debt and equity.

The global credit crisis of 2008-2009 raised the issue of alternative capital for credit unions to the forefront. Retained earnings are primary component of credit unions' capital. Adding alternative sources of capital enable credit unions to expand reach and maintain financial stability. Credit Unions across the nation need legislative support for such growth to make a greater difference for their members, reach new members, and better serve their communities.

To prepare this white paper, authors worked with the Permaculture Credit Union Board in Santa Fe, New Mexico. In addition, they conducted interviews and reviewed research papers, reports and relevant regulatory provisions. The motivation was to provide a clear outline of alternative capital sources for credit unions to consider as well as an "apples-to-apples" analysis of the alternatives.

3.0 Background

Credit Unions have evolved into increasingly competitive customer and community oriented providers of financial services. Growth rates in insured assets and number of US credit unions has increased significantly over the last decade. Credit unions have limited capital raising opportunities compared to commercial banks and other financial institutions. As a result, credit union rely on gradual retained earnings accumulation for growth.

Seven cooperative principles guide credit unions commitment to serving members and their communities: 1) Voluntary Membership; 2) Democratic Member Control; 3) Members Economic Participation; 4) Autonomy and Independence; 5) Education, Training and Information; 6) Cooperation Among Cooperatives and 7) Concern for Community. Feasible alternative capital sources must uphold these principles while building capital that counts towards net worth ratio.

4.0 Low Income Designation and External Funding Sources

The Credit Union Membership Access Act (CUMMA) of 1998 specifically allows low-income, federally insured credit unions to access alternative sources of capital to meet mandatory net worth requirements while overcoming challenges of low-income membership. NCUA is charged with certifying federally insured, low-income credit unions. The requirement for this designation is a simple majority of members who qualify as low-income. Low-income is defined as earning 80 percent or less of all wage earners or 80 percent or less of the median household income. Certain geographic areas adjust for increased cost of living, and students are included in the calculation.

Low-income designation by itself is not a source of alternative capital, but it is the means by which many gain access to external funding sources. Community Development Financial Institution (CDFI) and Community Development Credit Union (CDCU) are two possible designations.

4.1 CDFIs

Through its CDFI Fund, the U.S. Department of Treasury oversees CDFI certification to financial institutions serving underserved markets. CDFIs include regulated organizations like community banks and credit unions as well as non-regulated organizations like loan funds. As of April, 2010, there were 860 certified CDFIs. CDFI certification requirements include:

- Have a primary mission promoting community development
- Financing entity
- Primarily serve one or more target markets
- Provide development services with financing activities
- Maintain accountability to defined target market
- Non-government entity and not under control of any government entity (Tribal governments excluded)

Note: low-income designation is not specifically a requirement to gain CDFI certification; however, a low-income credit union qualifies under the "primarily serves one or more target markets" provision. Traditional credit unions may still qualify if they operate within specific geographic boundaries or serve target populations that lack adequate access to capital and have historically been denied credit. However, it is difficult, but not impossible, for traditional credit unions to gain CDFI certification without low-income designation. Native American CDFI designation is population-specific with its own programs within the CDFI Fund. Applications to become a certified CDFI are accepted on a rolling basis; applications for CDFI Fund programs have annual deadlines around September each year, with awards granted by the following June. CDFI funds are awarded on a competitive basis.

4.1.1 CDFI Fund Programs for Credit Unions

- CDFI Program Financial Assistance (FA) and Technical Assistance (TA) – FA awards provide funding for economic development, affordable housing, and community development. FA awards are granted as equity, loans, deposits, or grants, and must be matched by the applicant with similar funds from non-federal sources. FA requests are under $2 million; CDFIs leverage FA funding with other dollars on average 20:1. TA grants are for CDFIs and organizations seeking to become a CDFI to acquire technology, staff training, consulting services, or staff time to conduct capacity building activities. TA grants have a maximum request amount of $100,000.
- Community Development Capital Initiative (CDCI) – provides capital to CDFI credit unions that target more than 60 percent of its activities to underserved communities. This program offers subordinated debt to CDFI credit unions with dividend payments beginning at 2% and increasing to 9% after eight years to encourage repayment.
- Native American Program – offers several funding and educational programs.

- Capital Magnet Fund (CMF) – provides grants to CDFIs and qualified nonprofit housing organizations to fund housing, economic development, and community facilities.
- Financial Education and Counseling (FEC) Pilot Program – provides grants to financial institutions (including traditional credit unions) for financial education and counseling services to prospective homebuyers.

4.2 Other Institutional Sources of External Capital

There are an increasing number of institutions dedicated to assisting community development organizations, like credit unions. These institutions provide a variety of competitive funding opportunities and assistance to credit unions focused on serving lower wage earners, distressed areas, minorities, and other populations traditionally overlooked by mainstream financial companies. The National Federation of Community Development Credit Unions (the Federation) was one of the first such organizations, and it offers a variety of funding and educational assistance programs. Several funding opportunities from the Federation are outlined below as examples of the types of opportunities that exist for low-income, community focused credit unions.

The Federation is the body that bestows the CDCU title – it is not a legally recognized designation like CDFI. A CDCU meets all credit union regulatory requirements while serving the financial needs of those outside the area of banks and traditional credit unions. The Federation was organized in 1974 to represent these organizations before legislative and regulatory bodies and to expand the CDCU movement. A credit union must be a member of the Federation in order to be considered a CDCU. While most CDCUs have the low-income designation, it is not a requirement to join the Federation. However, a CDCU must have the low-income designation in order to participate in secondary capital formation programs offered through the Federation. The Federation partners with investors, trusts and foundations, non-profits and faith-based organizations, financial institutions, and governments to provide three types of capital raising products: deposits, secondary capital loans, and grants.

4.2.1 Federation Programs

1. Non-member Deposits – insured deposits by an organization or individual who is not a member of the credit union. Depositors receive share dividends at or below market rates.
2. Nominee Deposits – insured deposits from the Federation on behalf of a third party, but the third party is depositor of record and beneficiary of the deposit insurance. Depositors receive share dividends at or below market rates.
3. Risk-sharing Deposits – utilized as partial collateral against particular loans. Products include Micro-enterprise Collateralization Deposits, Predatory Relief and Intervention Deposits (PRIDEs™), and Assistive Technology PRIDE™. Micro-enterprise Collateralization Deposits are deposits that offset 25-33% of loan value to a micro-enterprise for business purposes. PRIDEs™ are Federation deposits used to collateralize 25-40% of principle for loans to fend off predatory/ abusive lending. Assistive Technology PRIDEs™ are loans for members with disabilities.

4. Secondary capital loans – provides capital similar to subordinated debt, a liability paid only after other liabilities are repaid.
5. Grants – Federation partners with foundations, non-profits, and government programs. They are donations for specific initiatives that do not require repayment.

4.3 Grants and Donations

Grants and donations are another source of external funding. Government entities provide grants to institutions that provide financial counseling and first-time homebuyer education.Grants may also be obtained for piloting a new product or service that can be used on a wide-scale basis.

Donations come from individuals and credit union members. The amount of funding may not be as large as a competitively awarded grant, but there are often less restrictions tied to donations. Some credit unions establish 501(c)(3) non-profit charities to help solicit donations and fund credit union programs. For example, a credit union may solicit donations to help fund Individual Development Accounts (IDAs) for low-income members to build savings for first-time home purchases, education expenses, or start-up costs for a new business.

5.0 Alternative Sources of Capital

Unlike competitively awarded external funding, alternative capital can be raised by a credit union for its sole purpose. Alternative capital is limited to low-income designated credit unions except in rare cases.

Alternative capital forms analyzed are: Member Paid-In Capital, Non-Member Paid-In Capital, and Subordinated Debt

5.1 Member Paid-In Capital

Description

Members provide capital and receive dividends equivalent to debt interest at a specified rate. Credit union can redeem member paid-in capital at its discretion.

Key Features

- Variable stated maturity date
- Subordinate to all other obligations
- Members receive interest payments only; face value upon liquidation of or redemption by c.u.
- Qualifies as tier 1 capital
- No voting rights; cannot be transferrable to non-members without consent of c.u.

Structure

Based on the Supplemental Working Capital Group of the National Credit Union Administration, two possible forms of member paid-in capital:

Voluntary Patronage Capital: Allow members with financial wherewithal (sophisticated individual investors) to support the credit union by contributing capital. This is a long term instrument paying out non-cumulative dividends subject to available earnings. Rules and regulations relating to capital adequacy, disclosures and compliance will apply.

Mandatory Membership Capital: Supplemental capital required from any individual seeking to join the credit union. Capital will function as equity and will pay out non-cumulative dividends subject to availability of earnings. The instrument is suggested to have uniform par value not to exceed $50. The instrument cannot be redeemed but will become payable upon death of a member or after a 5-year waiting period after full membership termination.

Pros	Cons
• Counts as equity; does not impact tax exempt status of credit unions • Investors don't suffer losses until all R.E exhausted to meet credit union's liabilities • Easy to implement • Well known investor universe	• Restricted to members only; ignores other interested investors

Case Example

State Employees Credit Union of North Carolina – Issued equity shares similar to Member Paid-In capital in the corporate credit union system. Current IRS ruling approving Member Paid-In Capital as an alternative capital source apply only to obligations issued by State Employees Credit Unions, but it is reasonable to assume that this could also apply to other credit unions. For more information, please see company website: www.ncsecu.org.

5.2 Non-Member Paid –In capital

Description

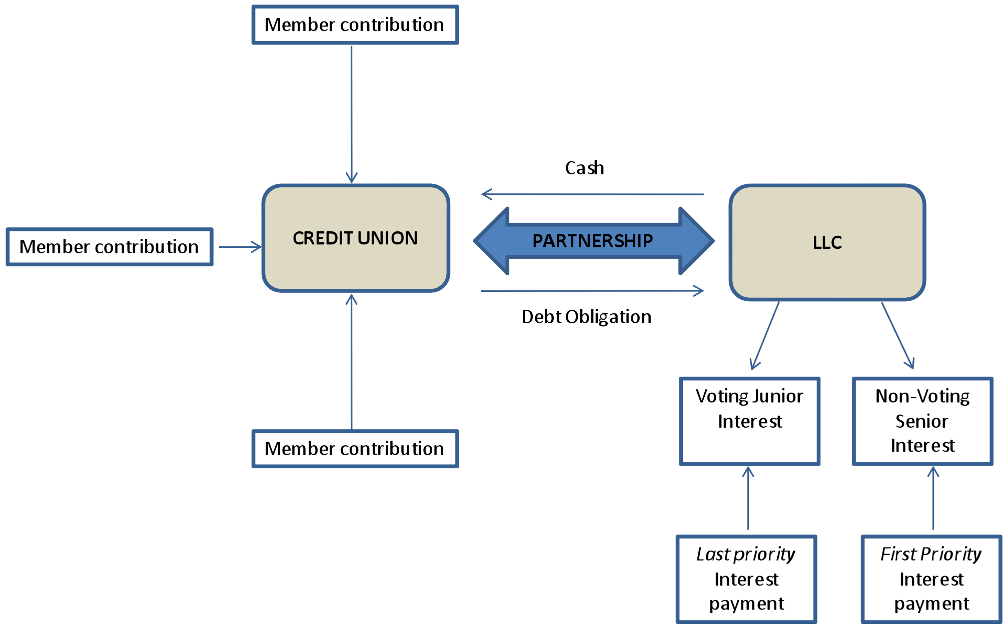
Capital obtained from outside sources, not members of c.u., via a shell for-profit company, such as a limited liability corporation (LLC). LLC owners contribute capital towards the LLC and receive full voting rights. The LLC then issues "non-voting senior interest" to other investors. Once capital is raised, LLC formalizes partnership with c.u. as a member. LLC receives voting right as one member.

Credit union pays interest to LLC which passes it to holders of "non-voting senior securities" before payments are made to "voting junior interests".

Key Features

- No voting rights
- No fixed maturity date
- Callable by the credit union any time after 5 years
- Tier 2 capital

Structure



Pros	Cons
• Does not change capital structure	• Relatively expensive to implement • Complex process

5.3 Subordinated Debt

Description

Hybrid equity/debt instrument limited to institutional investors. Subordinated Debt issues can only be up to 50% of the total capital of the Credit Union to be considered as Tier 2 Capital.

Key Features

- Maturity of no less than 5 years
- Regulatory approval necessary
- No early redemption option for investor
- Uninsured and subordinate to share account holders
- Cumulative interest

Structure

Subordinated debt is uninsured and comes after Voluntary Patronage Capital or Mandatory Membership Capital. Credit unions need to adhere to standard marketplace investor suitability standards and disclosures. Subordinated debt functions as a hybrid instrument, limited to institutional investors.

Pros	Cons

• Does not change capital structure • Promotes sound prudent corporate governance framework	• Direct competition with wider financial services market for investors • Limited to institutional/sophisticated investors

6.0 Analysis

While each option has unique benefits and challenges, all three alternative capital constructs are viable options. Three primary metrics were used to measure each option on an "apples-to-apples" basis:

1. **Cost of capital** refers to the overall transaction expense, including interest payments to investors and transactions cost to execute the deal.
2. **Difficulty** refers to complexity structuring transaction. This is important as the transaction is more likely to be successful when easily understood by c.u. staff and potential investors.
3. **Time to implement** is similar to difficulty, because a lengthy transaction may not be attractive to the credit union or the investor. It is important to distinguish between the two metrics, because some may be willing to overcome a complex transaction but may not be willing to wait the time.

Low Moderate High

	Member Paid-In capital	Non Member Paid-In Capital	Subordinated Debt
Cost of Capital	Moderate	High	High
Difficulty	Low	High	Moderate
Time to Implement	Low	High	Low

As a result of this analysis, member paid-in capital and subordinated debt are our preferred options, with time to implement and level of difficulty being distinguishing metrics.

7.0 Conclusions

This paper was written to provide insight into sources of capital for credit unions. Given the existing regulatory framework, these alternative capital options are available only to low-income designated credit unions. Alternative capital arrangements are rare for credit unions without low income designation and should only be pursued by savvy credit unions working closely with regulators and IRS.

A key finding of the research is successful low-income designated credit unions don't merely choose one or two funding sources. They proactively seek multiple opportunities available and creatively distinguish themselves for competitive financial awards. Such institutions leverage capital raised, and create a variety of organizational constructs including social venture capital funds, 501(c)(3) charitable organizations, and non-financial organizations to carry out their missions and serve the underserved.

ALL credit unions would benefit from access to alternative capital sources as low-income credit unions enjoy. This would provide the credit union industry with additional financial stability and growth opportunities while preserving the cooperative mutual credit model.

LIST OF ACRONYMS

Acronym	Term
CDCU	Community Development Credit Union
CDFI	Community Development Financial Institution
CMF	Capital Magnet Fund
CUMMA	Credit Union Membership Access Act
FA	Financial Award
FEC	Financial Education and Counseling
IDA	Individual Development Accounts
LIBOR	London Interbank Offered Rate
LLC	Limited Liability Corporation
NASCUS	National Association of State Credit Union Supervisors
NCUA	National Credit Union Administration
PCA	Prompt Corrective Action
PRIDEs™	Predatory Relief and Intervention Deposits
TA	Technical Award

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